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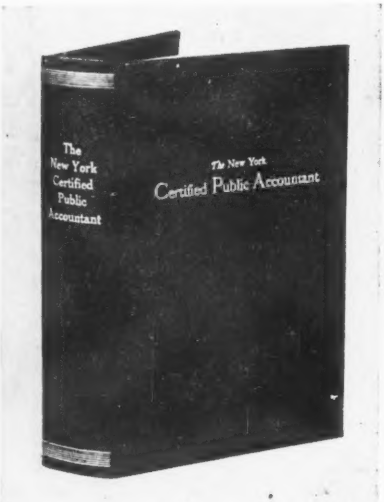

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The Accounting Profession in 1948

By GEORGE D. BAILEY, C.P.A.

GEORGE D. BAILEY, C.P.A., is a certified public accountant of Michigan, Ohio, and other states, and is a member of the Michigan Association of Certified Public Accountants. He is an alumnus of the University of Wisconsin, and a partner in Touche, Niven, Bailey and Smart.

He is president of the Community Chest of Metropolitan Detroit and a trustee or director of many other civic and philanthropic organizations. In the period of World War II, he was active in developing procedures for termination of war contracts, and served as consultant to the Office of Contract Settlement and other Federal government agencies on wartime accounting problems.

Mr. Bailey has long been active in the affairs of the American Institute of Accountants, of which he became a member in 1922. He has served on a number of its committees, including those on terminology, public utility accounting, and accountants' certificates. He was chairman of the committee on accounting procedure for three years.

A past vice-president of the Institute, Mr. Bailey was elected president of the Institute at the 1947 annual meeting.

This paper was presented at a regular monthly meeting of the Society held on April 12, 1948, at the Waldorf-Astoria Hotel in New York City.

I AM going to talk rather informally tonight about the public accounting profession in 1948, as I see it from my point of vantage as President of the American Institute of Accountants. The accounting profession has been growing so fast in numbers and in public acceptance that it has importance to our national society in 1948 considerably greater than in prior years. It is not too much to say, I think, that the public has suddenly recognized the accounting profession as mature and responsible and as being an important element in that society. As a result of this recognition, demands are being made upon the profession and attacks are being made upon its position. These, together with the activities within the profession to meet the new demands, are creating stresses and strains which are giving rise to many current problems and placing new responsibilities upon the profession.

This is no longer a small profession. The American Institute of Accountants itself has almost twelve thousand members, as against some four thousand in 1936. The magazine of the Institute, The Journal of Accountancy, has more than forty-five thousand subscribers, and, of course, an even greater number of readers. The state societies have grown substantially in membership. The Institute and the state societies, in their respective fields, and very often jointly, are recognized as the spokesmen for the accounting profession. In speaking on behalf of the profession, the Institute and the state societies have

been singularly independent in their point of view, and their representatives have made public appearances more often in the public interest than in their own. This has been true to such an extent that utterances of the accounting profession are considered authoritative —as the views of experts whose opinion must be carefully considered. Generally speaking, an independence has run through the relation of the accounting profession with the public, somewhat comparable to the independence exercised by auditors in the examination of financial reports.

The more experience I have with accountancy as a nation-wide profession, the more I am convinced that the essence of its standing is in its independence. It must always be able to speak impartially and objectively; and when it speaks for itself it must be careful to do so consistently with the national good. Of course there are areas in which we accountants may think the national good is best served by increasing the participation of accountants in specific problems. The rest of society may not entirely agree with us. However, we are entitled to have a higher belief in our helpfulness than others, if at the same time we are willing to take on the full responsibilities that go with that increased participation.

There is some evidence that the public can expect too much of accountants. Every once in a while there are suggestions, of which one made recently by Ralph Hendershot, Financial Editor of The New York World Telegram, is representative. Mr. Hendershot suggested that Congressional committees, for instance, might call in accountants as experts when they want to know something about the hard facts of business life. I think it is true that the experienced accountant does have an understanding of the way business is done, and the implications of business figures, that can be used much more than it has been. But I am afraid that Mr. Hendershot may be taking the accountants into an impossible area when he suggests that accountants can testify as to whether prices being charged the consumer are reasonable. Nevertheless, I hope it is indicative of the growing position of the accounting profession to have a man such as Mr. Hendershot even suggest the use of independent accountants in a field requiring much more than mere accounting knowledge.

We used to say that the accounting profession was not being called on in public investigations to the extent that its ability warranted. We used to point out that accountants were used in England in national affairs to a greater extent than they were in the United States. It is interesting to note that since the war there has been greater demand upon accountants in this country to assist in national projects, and a greater willingness on the part of accountants to give that assistance. You are all undoubtedly familiar with the fact that the Hoover Commission, investigating the operating structure of government in Washington, has called upon a number of accountants, including members of your own New York Society, to assume important responsibilities in that study. There was a similar call upon accountants to assist in a study of the operations of the Bureau of Internal Revenue. The assistance of a group of certified public accountants to the Appropriations Committee of Congress in studying the budget requests for last year and for this year is well known. There are many other less publicized but important relationships of accountants with government. At the same time it is pleasing to note indications that accountants are increasingly willing to offer themselves to assist in government, and of course if tax rates should start going up again there might be many more who would feel the same way. The profession is being given the opportunity to participate in civic and national activities and it has a responsibility to apply its peculiar ability in interpreting data for the national good.

The increase in stature and responsibility of the profession is gratifying. But it has also brought new problems, and aggravated old ones. I should like to discuss some of these specifically.

There is a charge that the profession is exclusive to the point of being monopolistic.

There are constant efforts in various state legislatures to lower CPA standards.

Some lawyers are trying to restrict the rights of CPAs in tax practice.

There is a lack of public knowledge and understanding of what a CPA is and what he does.

There are differences within the profession about auditing standards and accounting principles, particularly in relation to the effects of inflation on business profits.

There is widespread ignorance of the nature and function of corporation income.

These are problems which deserve examination in some detail.

Charges of Monopoly. The growing reputation of the accounting profession and, in a way, its increasing attractiveness, have given rise to a series of challenges that there are unwarranted special privileges which go with the term Certified Public Accountant. Claims are made that the difficulty in passing CPA examinations or in meeting the educational and experience requirements are so great as to create a small but favored class. The statistics showing the percentage who pass the examinations are cited as evidence that the requirements are much too high and that the public need does not require from the accounting profession standards which keep out such a large proportion of the men who wish to practice in it.

At the same time, there has been a tendency to increase the educational requirements, so it is claimed in many quarters that it is not only too hard to pass the examinations, but also much too hard to get the right to take them.

The accounting examinations do look hard to many people, but the greatest difficulty with respect to the examinations is in the field of auditing and accounting practice. Men of reasonable education and experience do seem able to pass the examinations if they put their minds to it, even though they may not be able to do so the first time. It has been the experience of the Institute over the years that the difficulty is not really in the examinations or in the requirements to sit for them, but in the fact that so many of the applicants are just not adequately prepared either by education or experience or intelligence, and that the great percentage of failures to pass is among applicants whose failure would be obvious to any reviewer.

The profession must not be too hard to get into, but it cannot reduce its standards very much without changing its entire nature. The plain fact is that accountancy is a tough profession which requires a high degree of ability, industry, and intelligence for its satisfactory practice; and that is the reason there is such a large percentage of failures to pass. In spite of it all, the profession is growing and will grow a great deal in the next few years, if the present enthusiasm among students in colleges is any indication.

The profession has no monopolistic point of view. The need for highly trained, competent accountants is so great that the profession itself is trying to increase its membership rather than to keep it on a restricted basis.

State Legislation. There is no gainsaying the fact that there is still a serious unanswered problem in this field. The Oliver bill, here in New York, was but one evidence that there is resentment against the restrictions upon entering that part of public accounting which requires the CPA degree. Fortunately, that bill has been repealed, but it was repealed only because of extremely good work on the part of the New York State Society—work which I am glad to say was aided by the American Institute of Accountants.

All through the country there is a growing group of people who are making a living out of bookkeeping for the public. Some of this work approaches very closely the work of some public accountants. There is no large gap between the work of some of the non-certified bookkeepers or accountants and some activities of certified public accountants. So there is throughout the country a considerable movement to change the relationships between the certified public accountant and the non-certified accountant. In some states this has taken the form of registering and regulating the non-certified accountant.

These increasing demands for recognition by the non-certified accountant have inevitably brought with them corresponding demands that the title of certified public accountant be emphasized to an even greater degree—one evidence of which is the agitation to change the name of the American Institute of Accountants to American Institute of Certified Public Accountants. As you know, the Institute, by an overwhelming vote, refused to change its name, not so much because one name is better than the other, but because many people were loath to modify a name that had made such great progress in public acceptance and had had enough recognition to distinguish it from other societies or organizations of accountants.

I don't know the answer to the controversy between the CPA and the non-CPA. One of the most controversial questions in our profession, and one that has been the center of stormy debate for twenty-five years, is regulatory legislation. Many of the state societies, and the Institute itself, have shifted their position on this question on more than one occasion. The Institute, just two years ago, finally developed a policy of favoring regulatory legislation, and promulgated a form of regulatory bill which it recommended. This policy and the bill have been under violent attack by some members, however, and the whole question is to be reconsidered again at the council meeting next month.

Eighteen states in this country have adopted regulatory legislation since 1924, and their experiences have varied widely—some pretty good, some very bad. A regulatory law passed in California in 1945, for example, included a provision that municipal and state employees might register as public accountants. There have been over 21,000 applications for registration, and as of April, 1948, nearly 12,000 permits to practice have been issued, only 2,202 of which are held by certified public accountants. There is, of course, a danger that the registered public accountants, outnumbering the CPA's ten to one, may press for waiver CPA certificates, or for reopening of the registration provisions, in order to perpetuate their status and increase their numbers. This kind of thing gives us pause. On the other hand, in my own state, Michigan, the regulatory law has been on the books since 1925, and has worked very satisfactorily. There are relatively few registered public accountants left there, and no one who is not registered is permitted to practice as a public accountant. We have, of course, a substantial number of public bookkeepers and tax consultants who are not registered. I personally do not think we can ever regulate these people out of existence.

The ultimate objective to be served by regulatory legislation is not to build a monopolistic fence around the profession, but to limit the use of the title "public accountant", and the certification of financial statements on which third parties may rely, to persons who will be subject to disciplinary control and will demonstrate their qualifications by passing the certified public accountant examination.

If this objective is not supported by the profession as a whole, or if it proves to be impracticable, then we must make up our mind to continue in the status quo, under which anybody who pleases may hang out his shingle as a public accountant, and CPA's must educate

the public to the great distinction which that one word "certified" creates, and must fight off forever the efforts of noncertified public accountants to secure some kind of legislative recognition.

The choice is a difficult one. It has been amply demonstrated that there is no security in any form of legislation. You in New York, which is a nonregulatory state, have suffered from the Oliver law, and I congratulate you on your successful fight for its repeal. In some regulatory states waiver bills have also been pushed through over the opposition of the CPA's.

So we have to fight on one front or the other, and our problem is to decide what is the major objective for which we are willing to fight, shoulder to shoulder, without discord or disunity among ourselves.

Lawyers. There has lately been an increasing attack upon the practice of certified public accountants by some lawyers or even, let us say, by the organized associations of lawyers, both national and local. For a long time this was rather *sub rosa* and informal, but lately it has become positive, open, and serious. For a time it was thought that the Institute and the state societies could work with the lawyers in such a way as to avoid inadvertent practice of one profession by members of the other and thus by self-discipline in both areas remove the dangers of conflict. That just did not work, because what the lawyers want is a restriction of the rights of accountants to deal with tax matters.

From the very beginning there has been an area of taxation that involved both accounting and law, but it was law in the sense of dealing with a specific tax law, which had as its core the matter of accounting. The accountants, because of their training, took over the making of returns and it was natural that they should take on the controversies in connection with tax returns.

Now the lawyers have asked that there be restriction upon the rights of accountants to practice in this way. The Bercu case in New York, with the first favorable decision reversed by the Appellate Division only today, is a striking exemplification of the lawyers' attitude.

There are similar evidences of restrictive activity in other states. The Unauthorized Practice of Law Committee of the American Bar Association has been advocating legislation that would make it much more difficult for accountants to practice before federal bureaus and agencies. The public accounting profession has opposed this legislation. The bulk of the opposition has been carried on by the New York State Society and by the American Institute of Accountants. It has been a joint effort that has been very satisfactory. The Institute believes that the legislation proposed, as it affects accountants, is completely unnecessary, but it is apparent that there is some very real demand in Congress that some legislation be passed to regulate practice before federal agencies. The Institute, while still maintaining its position that no legislation is necessary, has filed some suggested amendments which protect the certified public accountant but also protect the public against unnecessary burdens, or undue privileges to certain classes. This legislation is still in committee and it is impossible at this time to say whether it will be reported out at this session or not. Nevertheless, those of us who have been in contact with Congress are convinced that if nothing is done at this session the discussions will be resumed at the next.

The legislation now before a Senate committee which affects the right of accountants to practice before the Tax Court is still active and a representative of the Institute will appear before the committee on this subject. You will remember that before this bill passed the House a protective amendment was inserted which was reasonably satisfactory to accountants.

All of this is serious. It comes about from natural causes and the profession in its practice of accounting must be careful to do its work so impartially, so

soundly, and so intelligently that it does not leave itself vulnerable to attacks.

Public Relations. The Institute is undertaking a rather ambitious program of public relations. It has, as all state societies know, worked out a series of advertisements for use by the state societies in their local territories, if they care to. More than that, the Institute is embarking on a broad program to make public accounting really understood by the country. Some public opinion polls within the last few years have shown a much too low opinion of public accountants. They have shown a lack of knowledge of just what the public has a right to expect from public accountants and a lack of knowledge of the problems of financial reporting.

The Institute proposes to work on a long-range coordinating program of improving the public understanding of accounting and accountants. This is not designed to increase the use of public accountants, nor to get more people to have more accounting work done. It is as much as anything directed to an understanding of accounting and accountants by those who do not have occasion to employ accountants but who have occasion to rely on their reports. We want our profession to be understood for what it is, without over or underemphasis.

Auditing. The Institute has been stressing from year to year the necessity of a single standard of performance by all certified public accountants. It has advocated and propounded certain standards of auditing procedure. It would seem unnecessary to argue the point that auditing standards ought to be the same for all classes of work.

And yet the argument persists, and persists in my opinion to a greater degree than is generally recognized, to the effect that the auditing standards are all right for large firms but are too severe and too exacting for small firms. To such an extent is this true that many bankers want specific assurance from accountants as to the procedures followed in examinations. I have had it said to me many times by bankers that the standard certificate is all right in connection with those public accounting firms which are well known, but that it is not satisfactory in other cases because of the deliberate disregard of the auditing standards by some of the smaller accountants.

One of the worst things that could happen to the accounting profession would be to have the auditors' certificate have a two-class meaning—one for large firms and one for small ones.

Nor has it been particularly satisfactory to give a long form of report which spelled out certain procedures as having been followed, but gave no indication that all usual procedures were followed. In such cases it was incumbent upon the reader to decide whether the specific procedures did constitute an adequate examination. This situation was aggravated by cases in which procedures were stated without any concluding summary or certification.

This problem has long been recognized but it took a crusade on the part of a small accountant in the midwest to arouse the profession, and as a result the Institute Committee on Auditing Procedure issued its Statement No. 23 in December, 1947.

The committee took the position, in effect, that there should be a concluding paragraph either expressing an opinion or stating why an opinion could not be expressed. This statement is related to Extensions to Auditing Procedure which was approved by the membership of the Institute in 1939. Therefore it seemed wise to have the new statement in the same field also approved by the membership of the Institute at an annual meeting. The statement as submitted, therefore, is the opinion of the committee with all of the authority which that fine committee commands, but it is tentative pending membership action. I am not going to argue the statement at this time, but I regard its basic principles as essential to a healthy profession of large and

small firms. I think it will go far toward the elimination of a double standard of auditing.

Accounting. As accountants, I don't suppose we ever lose interest in what is taking place with respect to accounting techniques. A great deal has been going on over the past few years in the way of sharpening the presentation of corporate income. There is no need at this time to review the bulletins of the Committee on Accounting Procedure of the American Institute, or the other forces which have worked with the committee towards better accounting for corporate activities. With respect to accounting principles, the committee releases taking positions against general purpose contingency reserves, against such reserves as those for future decline in inventory pricing, and against the abandonment of depreciation on cost, have all served to decrease the variation in the accounting principles for the determination of income.

In addition to dealing with accounting principles, the Committee on Accounting Procedure has been giving attention to the matter of presentation of the income statement. It has reaffirmed quite positively its position that there are certain items which in certain conditions are properly excluded from the determination of the net income for the year, and should be so excluded. All of this has been in the interest of avoiding misleading inferences from the figure called "net earnings for the year," and making it more readily possible to judge the efficiency of the operations of the corporation for that year.

A basic objective of corporate accounting is to make income reporting comparable between companies. This is necessary so that operations of one company can be judged not only in relation to its own past but also in relation to other companies in the same period.

The results of any company's operations for a particular year cannot be judged in a vacuum. They must be judged against the backdrop of economic conditions of that year. The results for the year 1947, for example, considered against the economic conditions of 1947, have an entirely different significance from what they would have if judged against conditions in 1945 or, in the extreme, 1932.

Thus it is important that the impact of economic conditions of a particular year not be cushioned by arbitrary, permissive, unrestricted charges or adjustments. These not only destroy the usefulness of comparisons year by year for the same company, but completely destroy the reliability of comparisons between different companies.

Although accounting practices must be kept fluid to meet the changing needs of business, there must be a well understood body of accounting criteria against which the individual accountant's judgment can be tested. Otherwise there can be no comparability of financial reports.

Accountants have come a long way toward meeting the goals of clear, reliable financial reporting. The Bulletins on Accounting Procedure of the American Institute of Accountants provide a record of this progress. But there are still many problems calling for attention in the years to come.

The continued existence of the corporate system depends to a great extent on whether corporations provide adequate, trustworthy, and understandable reports on their activities. The necessity for such information is so great that, if it is not furnished under our present voluntary system, it is likely to be required by regulation.

To have governmental bodies responsible for the financial reporting of corporations would in my opinion be a serious loss to our economic system. Accountants must take their full share of responsibility to see that adequate information is given voluntarily rather than by government dicta.

Nature of Income. The foregoing activities have been in connection with what might be called the refinement of orthodox accounting. Ordinarily they would have constituted satisfactory

progress. Under reasonably stable economic conditions the accounting determination of income gave a figure useful to society and one which was not a great departure from economic concepts.

But with rapidly changing economic conditions, particularly the change in the value of the monetary unit, the determination of the earnings of corporations by orthodox accounting methods became subject to criticism, and that criticism continues unabated. Orthodox determinations of profit in a changing monetary unit no longer represent available or distributable profits, or even profits with respect to which there is a choice of use. In the first place, the purchase of inventory at one price and its sale on the basis of a different value of the monetary unit gave an orthodox profit; but insofar as this profit arose through the change in the purchasing power of the dollar, it was a profit that had to be put back in the business to replace the inventory used. Then, too, the fact that plant facilities were having to be replaced at costs very much greater than costs of facilities being used up, meant that reservation of profits for depreciation on costs just was not providing enough money for the replacement problem, and that earnings determined in an orthodox way could not all be distributed to the stockholders or used for expansion or considered in connection with increasing payrolls or reducing prices.

As these factors became more and more clear, and it became more and more evident that the profits which were apparently high in relation to prior years usually were just not sufficient to pay a reasonable dividend and let the company continue safely in its normal business, there came a demand that accounting reflect a different kind of profit than had been reflected under orthodox concepts. Profits determined in accordance with normal accounting methods were termed "phantom" profits, and other less euphonius words. The accountant was asked in many quarters to state net income for the year on a basis which would take out of the report all such "phantom" profits.

The accountant, while recognizing the need, had a serious problem. He had before him no general understanding as to what economic impacts should be considered in order to put corporate income on a current cost level, nor did he have any way of appraising or approving the amounts, or measuring those economic impacts. He would have found himself in a position of approving amounts determined by individual companies in the light of their own individual ideas of measuring the economic impact, and more than that he would have found himself approving such measurements in one case and approving financial reports without any such treatment in other similar cases. The accountants just could not give up all of the gains that had been made in connection with sharpening the determination of income under orthodox methods, and invite the chaos that would have resulted for a time if adjustments for economic conditions were left to individual companies without any criteria as to amounts.

On the whole, business seems to have accepted the decision of the accountants as necessary at the time and under the conditions. Most businesses therefore attempted to explain the effect of economic changes upon the availibility of profits determined in the orthodox way.

But this did not fully solve the problem. If we are to continue in disturbed economic conditions, orthodox accounting methods are going to show net earnings or net profits which will always have to be interpreted to be made useful. Accounting itself should be useful to our society, and particularly useful in the display and interpretation of corporation activities. There is no sanctity in accounting merely for itself; accountants must find a way of making accounting useful in this interpretation. If that means devising new accounting concepts or giving up some orthodox ideas, then they must be given up.

On the other hand, if we give up our historical ideas we must move into new

fields only when we have some knowledge of where we are going and what will be really useful in reporting corporate income. We need to know more about the nature of corporate income. If the economic concepts of corporate income should override the accounting concepts, how far should the impact of economic conditions be carried into the accounts?

Fortunately there has been initiated a study of accounting terms and definitions which will have as one of its most important and pressing problems the definition of business income. If that study does define business income in a form subject to accounting measurements, it should be possible without too much difficulty to put the definition into practice. If on the other hand the definition involves economic determinations, the group making the study should be able to suggest measurements to be applied in connection with such economic determinations. While the study is going on, it seems to me of little value to experiment with every possible method of reporting corporate income, or to open the field of corporate reporting to the inclusion or exclusion of economic impacts at the arbitrary whim of the individual corporation.

Under current conditions, this whole problem requires a great deal of study. It may be that there can be general agreement on extension of the LIFO principle to all inventories, or the adoption of some other agreement to reflect current costs with some adjustment of balance sheets. It may be that the violent fluctuations in the value of the dollar will not continue, and that the problems of the impact of economic forces will become less important in the year by year determination of corporate income. But we should not postpone our study in such a hope.

There has already been considerable study given to a single statement that would first determine the income for the year in accordance with orthodox accounting, and then show as part of the income statement the amount of profits that had to be reinvested in the maintainance of the same inventories, and the amount of profits that had to be retained for replacement of the equipment being used up. The difficulty with incorporating such figures in financial statements to be approved by the auditors is that it is often hard to distinguish between replacement and expansion, both for facilities and for inventories, and the resulting figure might be neither economic income nor accounting income, but rather a series of unreliable estimates.

By the same token, the fact that the Department of Commerce indicated that six billion dollars of profits for corporations for 1946 were inventory profits that had to be reinvested did not mean that any individual company could use the percentages so indicated without grossly misleading implications.

I deal with this at some length because it illustrates the principle brought out in the first bulletin of the Committee on Accounting Procedure of the American Institute that accounting must be useful to our society, and also the point that has been increasingly evident, that accounting must interpret corporation activity as accurately as possible. This is a major problem before accounting, and it has not been settled merely by the bulletin of the committee which, in effect, postponed a decision.

Understanding of Corporation Income. I referred earlier to Mr. Hendershot and his comments about accountants. Particularly I want to emphasize his statement that the man in the street could benefit a great deal from the observations of accountants on controversies about the nature of business, about the reasonableness of profits and prices, wages and dividends.

If it is true that the public would pay attention to comments from accountants, and I believe this, then accountants have a great responsibility to speak out. These are serious times. All through the world the system of free corporate private enterprise has

broken down save only in the United States and the countries closest to it. That breakdown has come because the mass of the people wanted a breakdown. Part of that desire came, I suspect, because of some abuses which might have been corrected without disaster if there had been more widespread understanding of the system.

Here in this country our system of free private enterprise, the corporation system, has functioned to the great benefit of all. Yet today it is under attack—for too high prices, or too low wages, or too low or too high dividends, as well as for being monopolistic, and on many other equally tenuous charges. If the system is voted out, it will be because of lack of understanding. We accountants, dealing with accounting as the language of business, must be in the forefront of the movement to properly and adequately report on corporate activities, on corporation profits and financial position. More than that, we must be in the forefront of the movement to see that the public adequately understands the profit system.

Are dividends too high? Can we not find some way of showing how stockholders have fared in the changing value of the dollar—a showing which I believe would develop the fact that dividends have actually decreased in terms of purchasing power.

Are profits too high? Are they really high enough to protect the stockholder in his investment? Are they high enough to furnish working capital and tools to permit the continuous health of the company? Are the profits high in relation to current values, or in relation to the full value of the investment, tangible and intangible? Have we made such a fetish of conservatism or original cost as to encourage misleading inferences as to the return on investment?

Are prices too high? Is it really because of deliberate policy, or because of velocity with only narrow margins of profit per unit? Do we do our share to show how little change is required to turn a profit into a loss?

Not only do we have a selfish interest in preserving the economic system that has called our profession into being, we have a social responsibility to use our peculiar talents and knowledge for its preservation for the good of all. We can help to educate the public about corporation earnings, we can help those groups assisting in the dissemination of corporation facts such as public relations people and financial editors, and above all we can help to see that the financial information is useful for judging the progress of corporations and that all facts are shown for the benefit of all those groups who have a stake in the proper division of the fruits of corporate activity.

Adequate corporation reporting is at the core of our system of free private enterprise, and we as accountants have a major responsibility to provide it and explain it.

Introduction to Discussion of Auditing Procedure Statement No. 23

By SIDNEY B. KAHN, C.P.A.

THE subject of this evening's discussion is Statement No. 23, issued by the Committee on Auditing Procedure of the American Institute of Accountants under the title "Clarification of Accountant's Report When Opinion Is Omitted". My assignment is to outline broadly the problem preparatory to elaboration thereon by the two speakers to follow. At best, all of tonight's papers are intended to be brief expressions on the subject, offered solely to provoke thought and stimulate discussion.

The introductory paragraph of Statement No. 23 reads as follows:

> "1. The presentation of financial statements on the stationery or in a report of an independent public accountant without a definitive expression clearly indicating the representations he is making as to their fairness tends to create uncertainties in the minds of those who do not have special information regarding the preparation of the financial statements. In such cases, these third parties have no basis for determining what inferences are warranted by the association of the accountant's name with the financial statements and may place undue reliance upon them."

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This paper was read by him at the regular meeting of the Society held on March 22, 1948, at the Waldorf-Astoria Hotel.

This is a terse although complete statement of the issue.

To go back to the beginning, in 1939 the membership of the American Institute of Accountants (and also the membership of our Society) approved a report of the Committee on Auditing Procedure entitled "Extensions of Auditing Procedure" (subsequently issued as Auditing Procedure Statement No. 1) which stated, in part:

> "The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion."

The Institute's committee now proposes a modification of its position in that it recommends that the phrase:

> ". . . limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion."

be amended to read:

> ". . . state that he is not in a position to express an opinion on the financial statements and indicate clearly his reasons therefor. He may also, if appropriate, comment further as to the compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an over-all opinion."

In essence, the change suggested would make it mandatory to state the reasons for the denial of an opinion

whereas heretofore such a statement was merely discretionary.

The statement goes on to illustrate the following practices which frequently give rise to the uncertainties mentioned:

> "(a) The presentation of financial statements on the stationery of the accountant without comment, opinion, or signature; or with the assertion that the statements are 'for management purposes only'."
>
> "(b) The omission of an expression of opinion or of a specific disclaimer of an opinion in a report of an accountant in which financial statements and comments on the scope of the audit are included."

In view of the amendatory nature of the subject matter of Statement No. 23 in relation to Statement No. 1, as previously pointed out, and the fact that Statement No. 1 had been formally adopted by the membership, the Council of the American Institute of Accountants has directed that Statement No. 23 be presented to the next annual meeting for formal action. Under the circumstances it would be appropriate and desirable to submit the matter to our Society for consideration and discussion at this time.

It may be that after a cursory first reading of the statement unfavorable reaction may be indicated on the part of some practitioners, obviously a result not unexpected. To such persons a careful study of the broad aspects of the document is recommended to the end that the problem of the profession as a whole be objectively viewed and considered. From this vantage point answers to specific problems of individual accountants will suggest themselves within the framework of the overall solution. Furthermore, a critical approach such as that suggested may prove many of the objections to be more apparent than real.

Having made these introductory remarks I shall relinquish the subject to the two speakers to follow who, in turn, will elaborate upon the discussion generally and may treat specifically with respect the short-form report, the long-form report and the interim report, and who will consider the problem as it may be met in connnection with both the large and the small enterprise.

Before concluding, however, I wish to express my firm belief that the statement is an unequivocal solution to a problem that has perplexed not alone ". . . those who do not have special information regarding the preparation of financial statements", as stated in the bulletin, but one that has also confused the minds of experts including public accountants. Obviously, the basic reason for this is the lack of uniformity of practice that has existed with respect to public accountants' reports other than the unqualified short-form report. Standardization suggests itself as the panacea. Under the circumstances it seems that Statement No. 23 should be regarded as a desirable official pronouncement worthy of the popular support of the profession at large. I most earnestly hope it will receive such support.

A General Commentary Upon Statement No. 23

By Gordon M. Hill, C.P.A.

It is my opinion that the statement under discussion, as with most of its predecessors, is called for by preceding events and states a logical position with respect to its subject.

In the Tentative Statement of Auditing Standards issued by the Committee on Auditing Procedure of the American Institute of Accountants, under the heading Standards of Reporting, it is recited that the ultimate objective of the examination of financial statements by the independent Certified Public Accountant is the expression of an opinion respecting the statements. Thus, departures from this objective should be looked upon as an exception to a rule.

The bulletins on accounting and statements on auditing procedure result from a constant effort to make of record those accounting principles and auditing procedures concerning which announcements are needed to assist in the unification of current thought. The effort is to standardize performance in order to make possible uniform understanding.

The necessity for these guiding suggestions is proof of progress in accountancy. As developments have posed questions, the most formal answers have been the Bulletins and Statements from the Committees on Accounting Procedure and Auditing Procedure of the American Institute. Their general acceptance is an indication they are meeting the needs.

Auditing Procedure Statement No. 23 seems to emanate from two main sources. One is the need of revising a paragraph in Statement No. 1, due to events traceable to its issuance.

In 1939, when Statement No. 1 of the Committee on Auditing Procedure, referred to as Extensions of Auditing Procedure, was issued, the basic statement therein was to the effect that verification of accounts receivable and of inventories as outlined therein was recognized as generally accepted auditing procedure. In logical sequence it was stated that it was recognized as necessary to so state when these generally accepted procedures were not followed; that if the procedures were not followed and it was so stated, it was necessary for an accountant to recite a qualification based on his limited examination; and finally that the opinion should not be expressed with a qualification of such importance as to negative the opinion. These steps follow one another almost automatically and Statement No. 2 commented specifically upon the expression of an auditor's opinion on the basis of a restricted examination, and outlined a situation wherein the limited scope of the work performed

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This paper was read by him at the regular monthly meeting of the Society held on March 22, 1948, at the Waldorf-Astoria Hotel.

negatived the expression of an opinion. No suggestion, however, was offered as to what should have been said by the accountant.

In the ensuing years accountants have developed their own ways of reporting on these situations until the differences in the reports issued began to demand some clarification due to the divergent treatment. If the recognized existence of certain situations makes it impossible for an accountant to express an opinion, it seems inevitable that the absence of the opinion will leave a kind of vacuum. If this vacuum is left unfilled it is almost an invitation to the reader to make some surmise, probably erroneous, as to the absent opinion. Or what may be worse, to make an assumption that when not stated to the contrary, the statements reflect the financial position and the results of operations in accordance with generally accepted accounting principles.

The second broad situation which I have referred to as a probable source of Statement No. 23 embraces all that reporting area referred to in the first paragraph thereof. This area includes all other cases than those originating under Statement No. 1, where financial statements appear in conjunction with an accountant's name, but where a standard opinion paragraph is omitted.

Consideration of the variety of situations in which an accountant could not express an opinion will easily show the inevitable lack of standardization which would exist in reports by different accountants in such situations.

This gets us back to the logic behind the issuance of this statement since all of the work of the committee has been toward standardization, including a standard form of auditor's report. There was no guide to a method of reporting on the situations in which an opinion did not appear and the Committee on Auditing Procedure was the natural heir to the problem.

To meet this situation the committee proposed an approach to be put in standard language, namely, that when an opinion cannot be expressed, whether or not desired by anyone, a positive statement that it cannot be expressed shall be made and the reasons therefor given.

The general statement seems desirable, namely that there should be a uniform approach in presentation of financial statements with which the accountant's name appears. This is particularly true since it is possible that financial statements without an opinion appear more frequently than with the standard form of opinion.

Let us consider another approach to the necessity for the statement. It is generally recognized that a Company is the author of its own financial statements and that the accountants' representations with respect thereto appear in his own report.

Where the accountants' name appears without any representation by him then, as stated in the first paragraph of the statement, third parties have no basis for determining what inferences are warranted by the association of the accountant's name with the financial statements.

There may be differences of opinion about the interpretation of the statement which need to be reconciled. As an example, in paragraph 1 reference is made to the presentation of financial statements on the stationery or in a report of an independent public accountant wherein a definite expression clearly indicating the representations of the accountant is lacking. The revised language in paragraph 6 says that when the scope of the examination has been less than the accountant considers necessary to enable him to express an opinion on the statements taken as a whole, he should state that he is not in position to express an opinion and give the reason therefor. Should it be deemed that an examination has been less than considered necessary when there has been *no* examination, or is it to be considered that an adequate representation has been made

when it is clearly stated that the statements are presented with no audit.

One other comment on the statement may be in order and that is that it should not be interpreted as having as a purpose the encouragement of denials of opinion. In spite of the fact that it attempts to make manadatory such denials, the effect of the statement may be the encouragement of either extending the scope of work done to the point where the denial would not be necessary or to discourage the client from expecting an accountant's name to accompany statements where no adequate representation with respect thereto could be made.

It seems pertinent also to mention that the statement only applies where financial statements are accompanied by an accountant's name. It clearly does not apply to the broad field of reports which do not include financial statements.

In considering the statement from the standpoint of the large practitioner it appears to give rise to little difficulty. In connection with work for large clients few reports are issued without an opinion. Where they are, the statement can be observed. For small clients the situation is probably similar to that encountered by smaller accounting firms, except that a reduced number of interim reports are probably issued. In some circumstances statements can be issued on plain paper, but where the accounting firm's name appears, it would seem reasonable to follow literally the statement requirements.

ACCOUNTING QUESTIONS and ANSWERS

The following inquiry was recently received at the office of the Society from one of our members. Since the questions and responses appeared to be of sufficient general interest, they are reproduced herewith for the general information of our members. They represent the considered opinions of the Committee responding, but they are not to be considered as official promulgations by the Society.

Questions

1. How should cash surrender value of life insurance on officers of a corporation be treated in the balance sheet, in current assets or below the current asset section?

2. How should loans payable to a bank on cash surrender value of life insurance of officers in a corporation be treated on a balance sheet, as current liabilities or below the current liability section?

Answers

1. Inasmuch as life insurance on officers is ordinarily taken out to provide funds in the case of the officer's death and not before, the cash surrender value of such life insurance should not be included in the current assets section of the balance sheet. This is covered by section 6d of the Accounting Research Bulletin No. 30 issued by the Committee on Accounting Procedure of the American Institute of Accountants in August 1947.

2. If money is borrowed from a bank and the life insurance policy is put up as collateral, the amount of the loan should be included as a current liability because there is a presumption that the loan will be repaid from sources other than by cashing in the life insurance policy. This is subject to the possible qualification that, if it is intended that the loan is not to be repaid, and if the bank is willing to carry it until the life insurance matures, the loan could be shown below the current assets or might even be shown as a deduction from cash surrender value. However, if this treatment is used, a specific statement should be made that it is not intended to repay the loan and a check should be made with the bank that that bank is willing to carry the loan indefinitely.

WARREN W. NISSLEY, *Chairman,*
Committee on Accounting Procedure

The Relationship of Statement No. 23 to Monthly and Interim Reports

By Stephen Chan, C. P.A.

I am in general agreement with the intent of Audit Procedure Statement No. 23. However, it seems to me that this pronouncement should be expanded to illustrate specific qualifying wording applicable in designated situations.

My phase of tonight's discussion deals specifically with interim or monthly reports. Interim financial statements may, for this purpose, be classified into three divisions:

(1) Statements prepared from the client's books of account, without any outside verification, and based on a limited or superficial audit.

(2) Statements prepared as the result of a detailed audit of the books and records, but without direct verification with outside sources or physical inventory taking.

(3) Statements prepared as a result of continuing complete audits, the scope of which include direct verification of receivables and payables once or twice a year, as well as annual attendance at physical inventory taking, although the outside verification does not take place at every statement date.

Statements prepared as a result of recurring complete audits and outside verification, backed by proper records and controls, may be submitted with an opinion and therefore do not concern us at this time.

Financial statements prepared without audit, if submitted on the accountant's stationery, should be clearly qualified so that no reader may attribute thereto any responsibility on the accountant's part. Those interested in this phase of the discussion are invited to read the article in the October, 1947, issue of *The New York Certified Public Accountant,* entitled "The Auditor's Responsibility for Monthly Reports".

The main problems in connection with interim reports, which I perceive in the proposed statement, relate to the second type of report, namely, financial statements prepared as a result of a reasonable audit, but without direct outside verification.

There is at present a lack of uniformity in the presentation of this type of report, ranging from those accountants who append an opinion or certificate thereto, to those who present the financial statements with no letter of transmittal and no opinion, and who qualify the balance sheet by footnote or headnote which states that it has

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been prepared without outside confirmation.

By its wording, Statement No. 23 seems to assume that a signed accountant's report usually accompanies these interim statements, and based on this assumption (which is not necessarily correct), it states in paragraph 4, and I quote:

> "Since the accountant cannot effectively control the use to which financial statements accompanied by his name may be put, the adoption of practices which will minimize the possibilities of uncertainties and misinterpretations by third parties is obviously to the interest of all concerned and should aid in the avoidance of embarrassment and damage to the profession. The committee on auditing procedure, therefore, recommends that, whenever financial statements appear *on the stationery or in a report* of an independent certified public accountant, there should be a clear-cut *indication of the character of the examination,* if any, made by the accountant in relation to the statements, *and either an expression of opinion* regarding the statement, taken as a whole, *or an assertion to the effect that such an opinion cannot be expressed.* When the accountant is unable to express an overall opinion, the reasons therefor should be stated."

The foregoing may be satisfactory procedure in connection with year-end reports, but, in my opinion, for purposes of interim or monthly statements, especially if no transmittal letter is customarily submitted, the substance of the foregoing paragraph 4 could be set forth in a balance sheet footnote, requiring no introductory paragraphs and no signature.

Suggested applicable footnotes should be incorporated in the statement.

One such balance sheet footnote may be expressed as follows:

> The above figures are set forth as a result of recurring audits of the books of account, however, since neither the receivables nor payables were confirmed by direct correspondence, and the inventory figure is not the result of a physical count, no opinion can be expressed in connection with these financial statements.

When a letter or report accompanies the statements, the scope of examination may be set forth in greater detail, and the qualification required by Statement No. 23 may be expressed in the last paragraph of the letter, somewhat as follows:

> Based on our examination as described in the foregoing paragraphs, the attached financial statements may present fairly the position of the ABC Co., at March 31, 1948, and the operating results for the three months then ended, in accordance with generally accepted accounting principles, however, since we did not confirm the accounts receivable or payable by direct correspondence, nor attend a physical inventory taking, we can express no overall opinion in connection therewith.

In closing, I state that even if this statement is properly amplified, and then adopted by The American Institute of Accountants' membership, it will be effective only if its precepts are observed uniformly by all members of the profession. It will be up to each of us to see that we revise our procedures, where necessary, to give effect to the requirements of the statement as finally adopted.

The Natural Business Year

By John L. Harvey, C.P.A.

One of the challenges to the profession of public accountancy is to convert industry to the idea of adopting the natural business year. The time has come when practicing public accountants should resume actively the campaign of educating business which was initiated back in 1935 and which was allowed to lapse because of the war.

The task is one of educating industry, the public and certainly some members of the accounting profession as well. Enthusiasm for the task must be developed among the members of the profession because it will devolve upon the individual practitioner to convert his clients. The efforts of the individual practitioner should be implemented by the wide dissemination of educational propaganda by the accounting societies. The committees of these societies should develop well-planned programs of education and should press these campaigns unremittingly through contact with trade associations, governmental agencies, banks, stock exchanges and other public and semi-public bodies. All available channels of disseminating information should be used. These would include public adddresses, articles in trade magazines, display advertising and distribution of literature. Money as well as energy should be spent on a project, the accomplishment of which would prove of such great benefit to industry, the public and the public accountant. It has been said that this program is unique in that it is of great practical advantage to all and is disadvantageous to none. It has, of course, been endorsed in principle by recognized authorities in the fields of business, government and accounting.

The Committee on the Natural Business Year of the American Institute of Accountants has taken up the cudgels and has initiated two constructive undertakings: 1) To bring existing records of natural fiscal years up to date as far as possible. 2) To secure publicity for the natural year in trade and industrial magazines.

State Societies should supplement this effort and endeavor to enthuse their members and to engage their efforts to convert industry through personal contacts with clients. It is evident that, if the individual practitioner is not sold on the idea, he cannot do an effective job of selling his clients.

One of the deterrents to the adoption of the natural business year is the fact that lawyers in general do not understand the advantages which would accrue to their clients through the adoption of the natural fiscal year and advocate the calendar year for no particular reason, unless it is that printed legal forms reflect this concept. Here is a fertile field for education. There is a tremendous amount of inertia to be overcome in this respect but, if the legal profession would cooperate, particularly in the formation of new companies to see that they are started on the right basis, the efforts of accountants will be well repaid.

It will be recalled that Dun & Bradstreet, Inc., prior to the war, made studies and printed reports on seasonal fluctuations and natural fiscal closing dates of various industries. They have decided not to continue this work because in so many cases seasonal variations, which were absent during the war, have not yet returned to many

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industries. This prompts the thought that now would be an excellent time to change from a calendar to a natural business year where the latter is indicated because of the fact that during the war and up to now in many industries, seasonal variations have not prevailed. This condition will render the comparative features of financial statements of little value when normal conditions return. One of the objections to changing to a natural business year was the fact that comparisons would be unavailable for a time.

The advantages which will accrue from the adoption of the natural business year have been repeated frequently. These advantages accrue to the public, to industry and, last but not least, to the members of the accounting profession who are in active practice. The more important of these advantages may be recited briefly again. The advantages to the public embrace those which are of advantage to any groups within the economy as a whole. If industry is benefited, the public, of which industry is a part, benefits. If the accountants benefit, the public receives that advantage. It should be pointed out, however, that the most important direct advantage to the public is the fact that financial statements, which are prepared at the end of the natural business year, which corresponds to the closing of a business cycle, are more dependable and more clearly set forth the facts of the business. The public is being educated to the doctrine that financial statements are not wholly statements of fact but include estimates which are to some extent contingent upon what may be expected to happen in the future. One of the most important of the items shown on most balance sheets is the inventory which is usually the largest factor in the determination of the profit and loss for a period. Inventory prices are matters of estimate and judgment involving costs and the probabilities as to market conditions at the time inventories are sold. It is not the time to price inventories on the basis of the lower of cost or market when they are high and consist of substantial proportions of raw material and work in process. In the first place, costs are frequently not determinable at that time and the disposal market is so far in the future that the element of estimate becomes almost a guess. Statements under these conditions are, therefore, less reliable. Statements, at any time, other than at the end of a business cycle, combine parts of two distinct periods or cycles. Other advantages can be called to mind, including the determination of a more correct tax liability when it is based on income accounts prepared at the close of a business cycle and the margin of error has been reduced to a minimum.

The advantages to industry include those recited above as being of advantage to the public in general. The more particular advantages to industry lie in the fact that they would receive a more efficient and economical audit, or in other words, better service at lower cost. Year-end adjustments would be simplified. New policies and changes in accounting and cost methods are most frequently introduced at the beginning of a fiscal year at a time when the pressure on public accountants is so heavy as to discount the value of their assistance in these matters. Inventory taking is made easier and physical inventories can be checked and tabulated with a minimum of interference with productive activity. There is less activity in the organization, as a whole, and, in consequence, there are more people to do jobs which must be done at the close of a fiscal year. Forward-looking budgets are easier to formulate and in most instances can be made more accurate.

The advantages to the practicing accountant are among the most important reasons for the adoption of the natural business year and in this connection it is recommended that the members of the New York State Society read the paper entitled, "Case

Studies on the Natural Business Year" presented by Mr. L. C. J. Yaeger at the annual meeting of the American Institute of Accountants. The physical and mental strain caused by the so-called "peak season" not only renders the work of the accountant of less value but also may have a serious detrimental effect on his health. That this is a life and death matter for the accountant is putting it strongly but there can be no question as to the need for immediate and substantial relief. The adoption of the natural business year will permit the development of larger permanent staffs and will make the work of the practicing accountant more attractive to the better university graduates. The spreading of work throughout the year should result in the elimination of periods of idleness and should permit public accountants to render services to their clients at lower rates.

Certain industries do not have natural business years. In such cases the appeal of the public accountant to change to a fiscal year must be on the basis of the advantage to the economy in general and to the practicing accountant in particular. Substantial advantages to the economy as a whole would unquestionably flow from the adoption of a fiscal year other than the calendar year by companies engaged in like business.

It is clear that many companies will not change solely on the basis of recited advantages and the general endorsement of the policy. A specific suggestion is needed and the public accountant is the logical one to make it. It is probable that the most convincing argument which an accountant can use will be on the grounds of personal necessity.

A great deal of work has been done since the campaign to induce corporations to change was inaugurated in 1935. A great deal, however, remains to be done and this will require unremitting efforts on the part of accountants to bring about the changes which will be of so great advantage to their clients and to themselves. It has been said that the greatest friend to the unnecessary calendar-year closing is the apathetic auditor. It is up to all of us, therefore, to overcome this inertia and get on with this campaign.

AN ADIRONDACK VIEW

Well, this straightens out that—or vice versa. The following is 200 proof—not a figment of any mountain member's mind:

"MEMORANDUM Date: 1/7/48

"To: Evelyn From: Norma

"On the money I was off, I didn't find anything. On the report of 12/26 I actually had $16.00 over what I was supposed to. For the report of 12/24 I was $5.70 short in cashing up, 12/26 report $5.00 short, and 12/27 $19.95 short, which makes a total of $30.65. When I made the bank deposit for 12/27 I was over $41.05 in order to leave a balance of $85.00. This left a difference of $10.40 ($41.05 less $30.65). Could it be that I was really over this in the beginning and not short at all?"

* * *

Which reminds us to remind our members to take proper steps, at the top level, or the higher bracket, or something, to see to it that our reports, and letters, don't need an interpreter in the client's office. And, perhaps, what is good up in the mountains is also good up in the skyscrapers—or more lowly office buildings of the Mohawk Valley, Buffalo included.

Its going to be really tough getting our members straightened out again this year at the conference at Saranac Inn in June. They had a tough winter and didn't have time to read all the magazines, tax services and newspapers.

LEONARD HOUGHTON, C.P.A.
President et al., Adirondack "Chapter"

Income Tax Features of the Revenue Act of 1948

By William L. Weiss, C.P.A.

The significance to all of us of the new Federal Tax Law is readily apparent, but we will have to wait for the future to resolve the ramifications and various effects which it may very well cause. After May 1, take-home pay will increase. Will this bring relief to wage-earners, or will it cause a corresponding inflationary increase in prices? Will individual investments fostered by the favorable tax provisions spur businesses? Will the lowered individual rates cause a trend toward partnerships and proprietorships and away from corporations? Outside the scope of pure economics, to what extent will marriages be encouraged because of the fact that, by the grace of Congress, two can now live taxwise more cheaply than one? Does the special treatment accorded to the aged and the blind point towards a trend of fashioning social reforms through tax laws?

There are, however, immediate and calculable effects of the revisions in income, gift and estate taxes; this article will concern itself with the income tax features. The major changes in the income tax law are:

1. Decrease in rates.
2. Increase in exemptions and dependency credits from $500 to $600, and granting of additional exemptions of $600 to those over 65 years of age and to those who are blind.
3. "Community-property" splitting of income between husband and wife.
4. Increase in maximum optional deductions from $500 to $1,000.
5. Several miscellaneous provisions relating to: Maximum deductions for medical expenses, withholding of taxes, revised declarations of estimated taxes, alternative tax on capital gains, limitation of income tax, effective date and fiscal years.

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Decrease in Rates

The 1947 taxes were based on a tentative normal tax of 3% and on tentative, graduated surtax rates from which a 5% reduction was taken. The new Act retains these tentative rates, but substitutes for the 5% reduction a series of reductions as follows:

Surtax Net Income	Reduction in lieu of 5%
On first $ 2,000.00	17%
On next $134,719.10	12%
On balance over $136,719.10	9¾%

The amount of the reduction can best be visualized by this comparison for an unmarried taxpayer:

Net Income Less Exemptions	Tax-1947 Rates	Tax-New Rates
$ 2,000	$ 380	$ 332
4,000	798	719
6,000	1,292	1,177
8,000	1,862	1,705
10,000	2,508	2,303
20,000	6,897	6,369
50,000	25,479	23,582
100,000	63,954	59,222
200,000	148,979	139,260

The new rates apply to individuals, estates and trusts. The optional table for adjusted gross income of less than $5,000 has been revised downward in accordance with the reduction in rates.

Increase in Exemptions and Dependency Credits

These allowances have been raised from $500 to $600 for individuals, estates, and dependency credits. Accordingly, husbands and wives may claim $1,200 in joint returns. This liberalization by Congress frees 7,400,000 individuals from tax liability and is responsible for the major portion of the reduction in Federal tax revenues. The exemption of trusts remains at $100.

The marital status at the end of the taxpayer's year controls as to his right to claim his spouse's exemption if she has no gross income and is not the dependent of another person. If his spouse dies during the year, the date of death is substituted. Unlike the former law, an individual is not considered married if he is legally separated under a decree of divorce or of separate maintenance, even though he is not absolutely divorced.

While the new law increases the exemption for a dependent to $600, it retains the former restriction that a dependent cannot earn over $500. This offers a further premium to those potential dependents whose gross incomes hover around $500 to keep "under the line".

Supplementing our social security laws, there is allowed an additional exemption of $600 to those who are over 65 years of age. Similarly, an additional $600 exemption is permitted to a person who is blind. Regarding both these extra credits, separate $600 allowances are granted to the taxpayer for himself and for his spouse, if they both qualify. To illustrate by an extreme case—a husband and wife who are both over 65 and who are both blind would have exemptions aggregating $3,600. The status on the last day of the tax year determines the eligibility for these extra exemptions. It should be pointed out that the extra dependency credits are not permitted to taxpayers having dependents over 65 or dependents who are blind.

Splitting of Income Between Husband and Wife

The splitting of income between husband and wife is the novel and distinctive feature of the 1948 tax law. This revolutionary treatment was designed to equalize the taxation of married taxpayers residing in common-law states with those in community-property states.

The tax for husband and wife is to be computed by first combining incomes, deductions, and allowances for personal exemptions and dependents, as in preparing a joint return. The limitations on the deductions for charitable contributions and medical expenses are based on the joint income, and capital gains and losses of the spouses are grouped. The resulting net income is then divided by two, the tax is computed on the quotient in the regular fashion, and then the tax is doubled.

Example: Assume husband's net income is $15,000, and wife's net income is $2,000, and the husband has one dependent.

Total Net Income	$17,000.00
Less: total exemptions (3)	1,800.00
	$15,200.00
(Divide by 2)	7,600.00
Tax thereon	1,599.20
Total Tax (Multiply by 2)	$ 3,198.40

If the former method of separate returns were employed, the taxes would be:

Tax for Husband	$ 3,653.12
Tax for Wife	232.40
Total Tax	$ 3,885.52

The effect of this manner of computation is to attribute one-half of the net income and dependency credits to each spouse and to level the income to

its lowest surtax brackets. The savings to taxpayers from this provision of the new law is substantial to those in the higher brackets, and is heightened as the net income increases. On the contrary, a husband earning $5,000 or less with a wife and two dependents obtains no tax benefit. In cases where both spouses have earnings, the savings attributable to this new feature are reduced as the earnings approximate each other. Then, too, this new version of "family unit" excludes from its advantages the widow, widower, and the unmarried head of the family, all of whom file in the same manner as an unmarried taxpayer.

Although this method of filing jointly is optional, it will result in a tax savings in practically all cases. It should *not* be elected only in the two unusual instances where:

1. The medical deduction of one spouse is so reduced when filing jointly (because it is based on the combined adjusted gross incomes) that the resulting tax, on the 50-50 basis, exceeds the total of the taxes on a separate basis, or
2. Both spouses have net capital losses aggregating over $1,000 (arising through losses during the year or carryovers) and their ordinary incomes are approximately equal or are moderate.

Examples: In both the following cases, it would be cheaper to file separate returns.

1. Assume the husband has medical deductions of $1,200 and the wife has none.

	SEPARATE RETURNS Husband	Wife	JOINT RETURN
Adjusted gross income	$2,500.00	$4,500.00	$7,000.00
Deductions (excluding medical)	500.00	900.00	1,400.00
Net (before medical deductions)	$2,000.00	$3,600.00	$5,600.00
Medical deduction (excess above 5% of adjusted gross income)	1,075.00	None	850.00
Net income	$ 925.00	$3,600.00	$4,750.00
TAX	$ 53.95	$ 525.60	$ 589.30
Tax of Wife	525.60		
Total taxes if separate returns	$ 579.55		

2. Assume the husband and the wife each has a net capital loss of $1,000 or more.

	SEPARATE RETURNS Husband	Wife	JOINT RETURN
Ordinary net income	$3,500.00	$3,500.00	$7,000.00
Net capital loss (limited to $1,000)	1,000.00	1,000.00	1,000.00
Net income	$2,500.00	$2,500.00	$6,000.00
TAX	$ 315.40	$ 315.40	$ 818.88
Tax of Wife	315.40		
Total taxes if separate returns	$ 630.80		

For the purpose of splitting income, the marital status is determined under the same rules as described above for exemption credits. If the taxpayer's spouse dies and he remarries during the same taxable year, he may avail himself of the community-property provision only with his new spouse.

Certainly, the husband and wife partnerships, which flourished during the war years when tax rates were high and which met close examination by the Treasury Department, no longer bear a tax advantage over a business operated as a single proprietorship. However, in those family partnerships where it is unsuccessfully contended that children are partners, the portion of income held not to be allocable to the children will be reported by their parents on a 50-50 basis. Similarly, the usual tax benefit motives for transferring securities and other assets by husband and wife sales will be eliminated, although the losses on such sales are still disallowed.

Of course, it must be remembered that the efforts of Congress to place the non-community property states on a par with their twelve neighbors and Hawaii does not alter the property rights of husbands and wives—nor the income tax laws of the individual states.

Increase in Maximum Optional Deduction

The ceiling for the standard deduction, which may be elected in lieu of specific deductions, has been raised from the former $500 to $1,000 in the case of a joint return or the return of an unmarried taxpayer. Many taxpayers earning over $5,000 will be doubly grateful for this provision—it will reduce taxes and, in many cases, it will eliminate the usual year-end scurrying to collect data to determine the amount of annual deductions. Liberalizing the maximum standard deduction also has the effect of greatly simplifying the examination by the Treasury Department of innumerable returns with incomes over $5,000, inasmuch as many more taxpayers will now choose the standard deduction.

If a married couple files separate returns, the maximum standard deduction for each return will be $500, as provided for in the former law. However, as illustrated above, in the discussion on income-splitting, it will rarely be advisable to file separately—and, in practical effect, a married couple electing to use the standard deduction will be permitted to deduct the lesser of $1,000 or 10% of their combined adjusted gross income.

Miscellaneous Provisions

Maximum Deductions for Medical Expenses:

Formerly, the maximum amount of medical expense deduction in the case of joint returns was $2,500. Under the new law, the maximum for joint returns has been increased as follows:

Where there is 1 dependent—to $3,750

Where there are 2 or more dependents—to $5,000

The rules have not changed with regard to the computation of the amount of the medical expense deduction with its reduction by 5% of the adjusted gross income, and with respect to the maximum deduction for separate returns of $1,250 where there is no dependent, and of $2,500 where there is at least one dependent.

Withholding of Taxes:

From May 1st on, taxes withheld will be decreased and wage earners, with two exceptions, will find that the law works automatically on their behalf. The only employees who will have to notify their employers at that time are those who are blind or who will be 65 in 1948, or whose spouses so qualify without claiming such extra exemptions on their own.

Inasmuch as the new law is retroactive to January 1, there will be excessive withholdings for the period January 1 to April 30, 1948, and amounts

due employees will be refunded after the filing of income tax returns due by March 15 of next year. However, because the new withholding rates are approximately the same as the lowest tax bracket percentage, these refunds will be reduced in many cases by the "under withholding" for the period in the tax year after May 1, 1948. Withholdings at the new rates apply to wages paid after May 1 without regard to the period in which they were earned.

Revised Declarations of Estimated Taxes:

The reduction in rates, additional allowances for exemptions and dependents, the splitting of income, and other tax saving features will reduce the taxes of those who filed estimations of tax. These persons should file amended declarations by June 15, basing their computations on the new law.

Alternative Tax on Capital Gains:

The alternative tax rate on capital gains has not been changed. However, where it formerly became effective with incomes over \$18,000, it now applies only when an individual has reached the net income, inclusive of the net capital gain, of \$22,000, and, for a joint return, the combined net income of \$44,000.

Limitation of Income Tax:

This note is for those concerned with income—ordinary income, not capital gains—of over approximately \$500,000 for an unmarried person and \$1,000,000 for a married person. The overall limitation, which formerly was 85½%, has been scaled down to 77%.

Effective Date and Fiscal Years:

The income tax provisions of the new Act are retroactive to January 1, 1948. Those with fiscal years beginning in 1947 and ending in 1948 will be required to compute tentative taxes first under the 1947 provisions and then under the new law. The final tax will be the sum of the portion of the tentative 1947 and tentative 1948 taxes arrived at with reference to the number of days of the tax year in 1947 and in 1948.

Fundamentals of Compensation Insurance

By Sol Bergstein, C.P.A.

It is generally recognized that the public accountant's audit responsibility embraces the review of the adequacy of his clients' insurance coverage. This review usually consists of a comparison of the amount of fire insurance carried with the book or replacement values of inventories and fixed assets, and a determination as to whether liability, fidelity, business interruption and other applicable forms of insurance are carried.

While the public accountant is not required to be an insurance expert, he is in the fortunate position of being able to gather a great deal of information on insurance by observing the practices of various clients. He should, in addition, make every effort to acquaint himself with the fundamentals of insurance. With the knowledge so gained, the accountant can very frequently be of real service to his clients by suggesting revisions that may result in substantial economies.

This article will be restricted to the fundamentals of compensation insurance, frequently, the largest single item of insurance expense. Most of the following remarks apply only to policies written in the State of New York.

The law requires that employees must be partially reimbursed for earnings lost and medical expenses incurred resulting from an injury sustained in the course of his employment or incidental thereto. Usually, this reimbursement is provided for by some plan of insurance.

The following rules prevail as to which employers are required, by law, to secure compensation insurance coverage:

1. All employers who have employees engaged in an occupation classified as "hazardous" by the law.

2. All employers who are not engaged in a "hazardous" occupation who have four or more employees engaged in manual work.

3. Employers of domestic employees who work a minimum of 48 hours per week where such employment takes place in a city or village of more than 40,000 population.

4. Private chauffeurs in all cities other than New York, farm labor, persons in teaching or non-manual capacities employed by non-profit institutions and clergymen are, generally, excluded. However, an employer who is not required to secure this coverage may do so voluntarily and thus limit his employees rights, in the event of injury in the course of employment, to those provided by the law.

The law also provides that part-time and casual employees must be covered.

An employee covered by the law has no remedy, in the event of injury, other than is provided by the law. Where an employer has secured insurance, the carrier is not limited to any total liability as is the case in all other types of casualty insurance.

Employers may not make payroll deductions to defray the cost of insurance coverage.

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Carriers

In New York State, compensation insurance carriers may be classified as follows:

1. Stock companies which are privately owned and which usually write all forms of casualty insurance. The assured pays the entire earned premium

subject to certain statutory discounts which will be discussed later.

2. Mutual companies are similar to stock companies except that in addition to statutory discounts on the earned premium, assureds may receive dividends further reducing their insurance expense.

3. Reciprocal insurance companies operate under a plan whereby the assured becomes in effect a partner in the company and shares in its profits and losses. The writer has been informed by the New York State Insurance Department that no such company is licensed in the State of New York and this form of carrier will not be discussed.

4. The State Insurance Fund is owned and operated by the State of New York. This carrier may not refuse coverage to any applicant willing to pay its rates, and may not cancel any policy for any reason other than the non-payment of premiums.

5. Self insurance carriers are those organizations who have qualified by the deposit with the State of such an amount of securities as shall have been determined by the chairman of the Workmen's Compensation Board. All claims are paid by the organization out of funds set aside for this purpose.

It should be noted that amounts set aside for self-insurance are not a proper deduction for income taxes. Finally adjudicated claims, however, are proper deductions.

Composition of Rates

Rates are composed of two parts and in the case of policies written by the State Insurance Fund, of three parts.

1. Manual rate
2. Experience modification
3. State Insurance Fund advance credit or special charge

All rates are promulgated by the Compensation Insurance Rating Board which is controlled by the State. All companies, including the State Insurance Fund, are members of this Board and may only issue policies approved by the Board.

Based on the incidence of accident and their related costs, standard or manual rates have been established by the Board for each of the various types of occupations and skills. To each of these occupations and skills has been assigned a classification code number. For example, clerical employees are classified as 8810 and the manual rate applicable is the same, generally, regardless of the type of business in which clerical activity is covered.

The experience modification charge or credit is determined by the Board by an evaluation of the experience of each risk—the factors being premiums charged and losses paid by the carrier. The following rules are in effect as to experience modification or rating.

1. The assured must be in business for two years.
2. The rating or experience period may not exceed three years or be less than one year.
3. The minimum average annual premium at manual rates may not be less than $500.00 unless only one year of experience is being used when at least $1,000.00 premiums must have been developed.
4. The rating period ends one year prior to the effective date of the policy rated, e.g. a policy whose effective date is January 1, 1947, will have modification rates established for the rating period ending December 31, 1945.

The manual and experience rates must be used by all carriers. The State Insurance Fund, however, may make an additional experience modification charge which is developed by its own underwriting department, or, at its sole discretion, grant an *advance discount* against the manual and experience rates of as much as 25%.

The earned premiums on policies, except retrospective, written by stock and mutual companies, are subject to the following statutory discounts:

	Stock	*Mutual*
First $1,000.00......	None	None
Next $4,000.00......	4%	4%
Over $5,000.00......	12%	7.4%

It is advisable for an assured to be capably represented at all hearings before referees who determine awards to employees and to ask for and carefully analyze the composition of experience rates.

Plans of Insurance

The types of coverage offered by carriers follow:

1. Standard
2. Retrospective Rating Plan
3. Group Plan

The Standard policy is one used by most employers. Under its term, the carrier in consideration of a minimum premium or one based on the assureds payroll undertakes to partially reimburse employees for their losses of earnings and medical expenses incurred resulting from injury sustained in the course of employment or incidental thereto.

The policy written by the State Insurance Fund is similar to those written by the privately owned carriers.

The Retrospective Rating Plan is available only to employers whose premiums are at least $5,000 annually. Under this plan, predetermined minimum and maximum premiums are established depending on the size of the risk. The results of the specific year covered are determined and adjustments made between the carrier and the assured with refunds to the assured of amounts no greater than would reduce his cost to the predetermined minimum or assessments by the carrier of amounts no greater than would result in costs up to predetermined maximum.

Many assureds, under this plan, insure themselves against the possibility of assessment by obtaining from the carrier, for an additional charge, a waiver of the right of assessment.

This plan is optional and need not be renewed from year to year. The statutory discounts discussed heretofore are not applicable to premiums developed under this type of policy.

The retrospective rating plan appeals to those companies who have an adverse experience rating resulting from unusual conditions and who seek to recoup part of their excessive insurance costs based on the expectancy of more favorable results.

The Group Plan is offered exclusively by the State Insurance Fund to groups of companies engaged in the same industry or trade. The advance discount on the manual and experience rate of each group member is 15%.

Each year the collective experience of the group is evaluated and where indicated dividends are declared. In the event of adverse experience, there is no assessment against the members but the incurred deficit must be eliminated in subsequent years in addition to the establishment of certain required reserves before dividends may again be declared by the State Insurance Fund.

Where either a Retrospective or Group Plan is in effect, the independent accountants' audit program should call for the examination of the status of possible refunds.

Maintenance of Payroll Records—Audits by Carriers

The law requires that accurate records be maintained of the number of employees and their remuneration. These records must be retained and available for inspection for at least four years after entries are made therein.

Remuneration of employee includes Bonuses, sickness pay, vacations, commissions and meals and lodgings, where provided.

Overtime is excluded from remuneration unless the employers' records fail to indicate the amount of the additional remuneration; e.g.—an employee earning $1 per hour who works 50 hours receives $55 of which $5 is not includable.

Effective October 1, 1946, that part of an employee's remuneration which exceeds an average of $100 per week may be excluded provided that the payroll records clearly reflect such remuneration.

Effective July 1, 1947, executive officers of a corporation may not exclude themselves from coverage and will be rated in accordance with the duties they perform. The $100 maximum average weekly salary rule is applicable to executive officers.

From the above, it will readily be seen that proper payroll records must be maintained if compliance with the law is sought. The following payroll column headings are suggested:

1. Regular hours worked.
2. Overtime hours worked.
3. Salary at regular rate under $100.
4. Salary at regular rate over $100.
5. Premium salary for overtime.
6. Other remuneration.
   a. Type
   b. Amount
7. Gross earnings.

The law makes contractors liable for payment of compensation insurance benefits to the employees of their sub-contractors. If a sub-contractor has not secured the necessary coverage, the contractor will be liable therefor.

The law requires that a deposit premium, based on the estimated actual premiums, be paid upon inception of the policy. If the policy is written on an anual audit basis, the deposit will approximate the full amount of the estimated annual premium. If the policy is written on an interim audit basis, the following basis is used:

Semi-annual audit	70% of estimated annual premium
Quarterly audit	40% of estimated annual premium
Monthly audit	20% of estimated annual premium

The deposit premium is credited against the final audit bill, all other audits, in the case of interim audits, being billed in full.

Carriers must make audits at least once a year in those cases where the annual premium is $500 or more. If the annual premium is less than $500, an audit must be made during the first year and at least once every three years thereafter providing the same carrier continues on the risk. For each year not audited, a signed statement showing the payroll must be obtained from the employer. In the case of interim audits, the carrier may accept reports from the assureds for all periods except the final audit. A carrier may also accept a signed statement from certain other small risks.

Policies may be cancelled at any time by either the carrier or the assured with the exception of the State Insurance Fund, which has the right to cancel only for non-payment of premiums. Cancellations by other carriers do not become effective until at least 10 days after notice of cancellation is sent to the assured. An employer insured by the State Insurance Fund may effect cancellation of the policy by sending written notice not less than 30 days prior to the expiration date of the policy. With other carriers, an employer may effect cancellation at any time without the requirement of notice.

In the event of cancellation by the carrier or by the assured upon retiring from business, the premium adjustment will be on a pro rata basis. In most other cases of cancellation, the premium adjustment will be on a "short rate" basis.

The foregoing general outline of workmen's compensation insurance, in the writer's opinion, represents the minimum degree of knowledge the public accountant should have. No attempt has been made in this article to discuss the subject beyond its fundamentals. In most cases, the accountant's responsibility should cease upon his recommendation that expert insurance counsel be consulted.

Preparing a Paper—The Final Step

By John Mantle Clapp

"I wish that our members," one of the Society's wheel-horses remarked lately, "would read their papers better at a meeting. Two of the men tonight just talked from notes and what they said got attention and discussion while the written papers did not. There's an article in this month's *New York Certified Public Accountant,* a very good contribution, but when it was read at a meeting some time ago no one made much out of it. That happens over and over. Why is it? Reading a paper isn't difficult."

Perhaps his comment was severe. Reading a paper at a meeting is not so easy as might be supposed. It involves taking material arranged for eye perusal and conveying it to other people *via* their ears, without altering its form, and that is not easy to do. We read papers badly because we forget the basically different organization of eye-material and ear-material, and this is difficult to bear in mind.

The ideas of talk are presented to us in small units, which our ears pick up and shape into complete thoughts virtually without effort—whereupon most of the words and even details of thought pass out of mind almost at once. The ideas of writing, on the contrary, are handed to us in larger units. Especially in accounting writing, details and sidelights that in talk would be separate remarks are woven into the main statements to form longer sentences. Since these written sentences are more concise than those of talk, it is not so easy for their full meaning to be taken in through the ears. And since they are fitted smoothly into paragraphs, missing a point here or there may mean, when we listen to a paper, a serious break in continuity. In writing or print, punctuation marks group the words and details for us. In conversation the grouping is indicated, of course, by changes in a speaker's delivery—in loudness, speed, pitch and quality of voice, sharpness of emphasis. But in listening to a paper we have none of these aids, neither punctuation nor expressive delivery. Everyone knows the change in atmosphere when a reader looks up from his manuscript and "ad libs" for a moment. In fact, getting a satisfying understanding of content from a paper that is read aloud may be almost as difficult as it would be to puzzle out a page of print without punctuation marks.

When listening to the paper, moreover, we have no way of correcting wrong impressions. With the typed or printed page, the eye retains a picture of what went before and even glimpses what lies ahead. And at any time we can turn back and re-read. Whereas, when listening we must follow right along from one remark to the next. Indeed, since the ear-memory of words and details is so unreliable, checking back to compare what has been said would be of slight avail. If we get a wrong meaning from a passage, or no meaning at all, there is no recourse.

Obviously, conveying eye-material to other persons through reading it aloud is no lazy man's affair. Yet very intelligent persons ignore the need of conscious effort to overcome the difficulties

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of transmission. We all assume that our powers of rhetorical analysis and our skill in vocal expression will function automatically, without calling for adjustment and preparation. Unfortunately that assumption is wrong.

This is what happens, too often. A man has a paper to read, perhaps one in which he has invested hours of labor. With little preparation, if any, for its actual delivery to the audience, he proceeds to utter what he has writen down much as if he were conversing at his desk—somewhat more loudly, of course, if the meeting is large. As the material is familiar to him he is almost certain unless alertly on guard, to be hypnotized by the smooth flow of the typed sentences. So that, aside from following the punctuation of the manuscript, indicating comma and period pauses as we all learned to do in school, he will utter sentence after sentence with little change of manner or speed. The result of the monotony is inevitable. The listeners will follow for a while, piecing the word-groups together, but gradually they lose connection. Thereafter what their ears bring them is little more than waves of sound, neither differentiated nor unified. All of us know highly intelligent men, whose conversation is brisk and expressive, but whose reading utterance slips invariably into a steady drone, like the hum of a sewing machine. When their reading ends, the audience has a sadly inadequate notion of what the author has labored to give them.

This is too bad. The veteran Society member was right in his judgment. For reading a paper properly is entirely within one's power. One simple rule will give what might be termed ear-punctuation to a man's reading. He has merely to go slowly, perhaps twice as slowly as he thinks necessary.

All of us are prone to forget, when we read a paper aloud, that the material which has become so familiar to our minds in the process of analysis and formulation is strange to our hearers. For them to grasp it, point by point, they must be given time. But merely remembering to read slowly will go far toward overcoming the difficulties of transmission. For if the ideas are good, they will hold attention, provided the reader can remember not to go faster than those he addresses can follow.

The extra time will be occupied, not with sounding words or phrases with unnatural slowness, but with pauses that mark off plainly the logic-groups into which the words fall. "Give the child time to swallow!", one of my old teachers used to warn me.

The pausing will not always correspond with the eye-punctuation. Composition classes bid us insert a comma after a preliminary phrase such as "For example," or "In this case." But in talking, natural extemporetalking, we rarely pause after such a phrase; we say "For example you need to do so-and-so," or "In this case the proper course to follow is . . ." Do the same when reading aloud. When you reach the end of the logic-group, however, to "do so-and-so," or "the proper course to follow is . . .," then make a real pause, to allow your listeners to consider the ear-ful you have given them. There will be appreciable pauses within a sentence, longer ones between sentences, which listeners can recognize as marking sentence-ends, and still longer ones at ends of paragraphs. Manifestly, the time required for all these pauses after logic-groups will amount to an extra fifty or even one hundred per cent.

But if you remember to insert plenty of pauses, proportioned in length to the significance of the logic-groups—as in eye-punctuation we have commas, semi-colons, periods, and so on—you go a long way toward avoiding the monotony that infests most oral reading. And then your natural impulse to expressive utterance will come into play as in spontaneous talking; you will be freed, at least in part, from the hypnotic spell of the unbroken flow of typed

sentences. Your reading will come to the ears of listeners with the directness of talk.

Here is a passage from a radio talk by Mayor O'Dwyer on December 5th, last year, the announcement of his momentous decision to recommend raising the New York subway fare from five cents to eight cents. Mayor O'Dwyer is not a showy orator; he talks very simply. But this radio script was read with the greatest care to have all his statements understood and their interrelation grasped by a multitude of listeners. His careful use of pauses, moderate ones within a sentence, longer ones between sentences, and still longer ones between paragraphs, was notable. In the following transcript of one passage I have indicated the mayor's pauses by groups of dots. Read it aloud, with pauses of proportionate length, and see how definitely the pausing aids in making the meaning plain.

> Reluctantly I have come to the conclusion . . . that at this time . . . whether we like it or not . . . we must not let our transit operating deficit upset . . . and stand in the way of . . the city's other vital needs . . . . . .
>
> The operating deficit is the amount . . . by which the fares collected . . . fall short of paying the actual cost . . of operating the transit system . . . . Until 1946 there never was an operating deficit . . . . . . And then it arose as a direct result of the necessary increases . . . in wages . . . and the cost of operation . . . . Next year it will be necessary to provide more than $51,000,000 . . . . to cover operating deficits . . . . That means . . that the city would have to pay that deficit . . . out of its treasury . . . rather than using that money for other essential purposes . . . such as hospitals . . health . . health insurance . . public welfare . . and other essential services . . . .
>
> As long as the City Treasury continues to pay the transit deficit . . . it can only do so at the sacrifice . . . of other essential services . . . . .
>
> An increase in fare . . of not more than three cents . . . is estimated to be sufficient . . . to cover the operating deficit . . . . . . Large speculative and investment realty interests have . . . for a long time . . . been agitating for a self-sustaining fare on our transit lines . . . . What they sought to accomplish was . . . to make the travelling public . . . pay the entire cost of the city's transit system . . . . They wanted the riders to pay the debt service . . . . . . Do you know what the debt service is? . . . . . . It is the amount of money paid annually . . . for principal and interest . . . on the money the city borrowed . . . to pay for the transit system . . . . . . a system from which real estate is the chief beneficiary . . . . . . and from which it has derived . . . . the maximum benefit . . . . . .

Mayor O'Dwyer must have laid out his speech in advance, perhaps even marking in the pauses with lines of varying length. The result was that he knew what he was doing. He was able to feed out his thought bit by bit, sure that his thousands of listeners would be able to grasp it as it came, and put the bits together in large blocks, as he desired. Thus his reading came to his listeners' ears virtually as if he were putting words and sentences together in an extempore speech.

Here is another example. As a rule our difficulty in following a paper does not arise at the points of chief emphasis. The reader is likely to stress these keypoints, so that we grasp them. Our trouble comes, however, with the intermediate material, the detail of explanation or argument, on which the main points depend. When listening to an inspirational address or a political appeal such details are less important—if we are unable to digest them, or even to hear them distinctly, as the speaker sweeps along—it does not greatly matter. But with material such as accountants present, the character of the detail is vitally important. If we miss any of it we may be prompted to question the reasoning of the paper. And far too often the author forgets this fact, as he reads his paper to the audience. Knowing his material so well, he is prompted to carry us over this detail faster than we can go. Usually such passages are nowise striking or emphatic in nature; they merely pile up items of evidence. The reader tends to utter them colorlessly. If, however, he has taken thought to space them out, by means of rightly proportioned

pauses, they will come to our minds intelligibly—not overstressed but distinct.

In the following paragraph from a well-written paper recently printed in this magazine certain details of an accounting situation are given in eight sentences that are explicit although not emphatic.

> The effect of this "balance-sheet" method of computing gain or loss of a foreign branch is to consider as realized gain or loss the fluctuation in foreign currency prior to any sale or exchange. Thus, suppose a branch is set up with two pesos when the peso is worth one dollar and, while the rate of exchange remains unchanged, earnings increase the foreign cash to three pesos. If, subsequently, the peso falls to $.50, the balance-sheet method would show a loss of $.50. At the beginning of the year, the balance sheet shows three pesos but, converted at the rate at the date of the closing balance sheet (50 cents) this represents only $1.50 (3 x $.50). Hence, the difference in dollars at the beginning and end of the year ($2.00—$1.50) results in a loss of $.50. Actually, the branch earned one peso, which (had it not been a branch operation) would have been converted at the rate at the date it was earned or $1.00, so that the earnings, apart from the fluctuation in the exchange, were 1 peso or $1.00. However, under the balance-sheet method of determining income, the $1.00 profit is offset by a decline in value of the peso. Since the branch had three pesos which declined to 50 cents in value (or a total loss from such decline of $1.50) the $1.00 profit on operations, less the $1.50 loss on decline of the peso, results in a net loss of $.50.

Now it would be only too easy for the author of the paper, to whom these details would be of course familiar, to rattle off the eight sentences with hardly a pause, and with little modulation of voice. As a result, his listeners might get only a blurred notion of the meaning of the passage—like one's glimpse of near-by objects from a fast-moving train—and might well lose their grasp of the sequence of the paper. Yet the passage is very easy to understand when spaced out with pauses. The first sentence states the idea. Sentences 2 to 5 present an example, which sentences 6, 7, and 8 repeat and explain. All that is needed, to render the passage "crystal clear" is for the reader to insert pauses of varying length, somewhat as follows:

> The effect of this "balance-sheet" method of computing gain or loss . . of a foreign branch . . is to consider as realized gain or loss . . the fluctuations in foreign currency . . prior to any sale or exchange . . . . Thus . . suppose a branch is set up . . with two pesos . . when the peso is worth one dollar . . and while the rate of exchange remains unchanged . . earnings increase the foreign cash to three pesos . . . . . . If subsequently the peso falls to $.50 . . the balance-sheet method would show a loss of $.50 . . . . At the beginning of the year the balance sheet shows three pesos . . but . . converted at the rate at the date of the closing balance sheet . . 50 cents . . this represents only $1.50 . . 3 times $.50 . . . . . . Hence the difference in dollars at the beginning and end of the year . . $2.00 minus $1.50 . . results in a loss of $1.50 . . . . Actually . . the branch earned one peso . . which . . had it not been a branch operation . . would have been converted at the rate at the date it was earned . . or $1.00 . . . . so that the earnings . . apart from the fluctuation in the exchange . . were one peso . . or $1.00 . . . . However . . . under the balance-sheet method of determining income . . the $1.00 profit is offset . . by a decline in value of the peso . . . . . . Since the branch had three pesos . . which declined 50 cents in value . . or a total loss from such decline of $1.50 . . the $1.00 profit on operations . . less the $1.50 loss on decline of the peso . . results in a net loss of $.50.

The basic requirement in reading aloud is to make your reading sound as if you were talking. You can accomplish thus with little difficulty if you remember to plan your pauses beforehand, then your reading, even of a highly technical paper, will be followed by listeners with relative ease. They may or may not accept your views, but at least they will understand what you say. Now this, planning the pauses in your reading, is something that anyone can do. Frankly, if your papers are hard to follow I fear that the fault is your own; you have neglected one essential step in preparing them. It is as though you had printed your paper and distributed it without punctuation marks.

Why not, therefore, take an hour or two, beforehand, and study out the dis-

tribution of pauses—perhaps inserting lines of varying length, or rows of dots, to guide you while reading? Is this too much time to spend? You may have given long consideration and careful rewriting to the paper; why neglect this final step?

Doing this, moreover, will enable you to utilize additional devices of ear-punctuation. The pauses will clear up the sentences, and to a degree their grouping within paragraphs. But to present the paper satisfactorily as a whole you should indicate also the inter-relation of paragraphs and sections. This calls for further differentiation in your utterance, with respect to relative loudness, changes in rate of utterance, and in the pitch and quality of your tones. All these are elements of spontaneous talking. If you have provided for the pauses, you will be able to attend to these other features; these also may be considered in your planning. I do not mean "elocutionizing," of course; that would be entirely out of place. I mean the varied presentation that comes, spontaneously, in animated conversation. And surely your reading of a paper should be "animated"; you are presenting it to that group because you want their reaction; you would not spend your time on the matter, otherwise.

Look at another passage in a recent paper in the *New York Certified Public Accountant,* this time on pages 97 and 98 of the current volume, in the article entitled "*What to Do When You Have a Fraud Case to Present for your Client.*" The last two paragraphs on page 97 sketch briefly what the accountant must do, in working up his facts. The five sentences would be uttered briskly, with pauses to mark off each of the points mentioned. Then the first paragraph on page 98 would be uttered slowly, earnestly. It comments upon what has been said. The second paragraph on page 98 is entirely different in character; it gives a swift review of the steps through which a "case" may proceed. It would be uttered rapidly, the voice rising in pitch from one "step" to the next. The third paragraph on page 98 is another landing in the author's progress, the conclusion, indeed, of the discussion that began at the first paragraph on page 97. It would be uttered even more slowly and weightily than the first paragraph of page 98. If the author has his pauses clearly determined, it will be easy for him to indicate very plainly the significance of these contrasting moves in his presentation.

Reading papers aloud is necessary in the scheme of things. Talking from notes, however interesting, is usually a temporary stage in the formulation of worth-while material. The topic covered in your paper may be timely, and interesting to the group even though nowise momentous. It may, on the other hand, be of great importance, which it is most desirable to have presented in this way, so that discussion and correction may be called out before the material is finally printed. And if this paper is read properly its oral presentation can be illuminating. Implications in the thought can be indicated to listeners which quite possibly might escape notice if the document were merely perused in print, at the close of a busy day. Uttering his ideas aloud gives the author an opportunity of interpreting them. He should grasp the opportunity.

Addendum: On April 20th after these paragraphs went to press Mayor O'Dwyer made another radio speech, this time to announce the increase in traction fares. He spoke with the same careful use of pauses as in his talk last fall. Even more noticeable this time was the animation of his delivery. The Mayor does not elocutionize. But he was very much in earnest. And because of the careful spacing and timing of his remarks, his voice and manner reflected his feeling spontaneously.

New York State Tax Clinic

Conducted by Benjamin Harrow, C.P.A.

Partnerships

A partnership is not a taxable entity for income tax purposes. A transfer of property by a partner to a partnership is therefore not a completed transaction. For example A, a partner, owns a security which cost him $1,000. He transfers it to a partnership at a time when it is worth $1,500. That is not a taxable transfer and A is not taxed on the gain of $500 even though he receives a credit of $1,500 in his capital account. It would be otherwise if A were to transfer the security to a corporation in exchange for stock, unless the exchange came within one of the exceptions to the rule that exchanges are completed transactions. If the partnership disposes of the property, a taxable gain or deductible loss results and the basis for determining the gain or loss is not $1,500 but the cost of the security to A, namely $1,000. Whether A is then to be taxed upon $500 of the gain or whether that portion of the gain is taxable to all the partners according to the ratio in which profits are shared will depend upon the partnership agreement although it would seem to be equitable to tax A on $500 of the gain.

A more interesting situation develops when property is transferred in kind to a partner. The regulations (Art. 493k) say that no gain or loss is realized by the partner until he disposes of the property. The real problem is one of the basis for determining the gain or loss. Art. 491e says that the basis shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property. What does that mean? The regulations do not elaborate on this but similar provisions under the federal law perhaps supply the answer.

The essence of the transaction is that the partner's capital interest is being recovered. Hence the basis of this interest must be recovered before any gain can result. If the assets of the partnership are distributed in kind, the basis of the partnership interest must be distributed among all the assets, each separate asset taking an allocable part of the basis of the partner's interest. The allocation is made in accordance with the fair market values of the assets at the time of distribution. For example, suppose the partner's interest or basis is $36,000 and that the total fair market value of all the assets distributed is $40,000. Included in the assets is real estate carried on the books at a cost of 3,000 but having a fair market value of 4,000. In the hands of the partner the real estate will have a new allocated basis of 4,000/40,000 x $36,000 or $3,600.

Benjamin Harrow, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University. Mr. Harrow taught accounting at The College of the City of New York from 1919 to 1924. He has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is presently serving on the Society's Committees on Federal Taxation, State Taxation, Cooperation with the State Education Department and Its Agencies, and Cooperation with the Bar. Mr. Harrow is engaged in general practice as a certified public accountant in his own office in New York City.

Since a gain on realization of an interest in a partnership is a capital gain it would seem that the resulting gain on the assets distributed in kind should also result in capital gain since these assets represent the capital interest in the partnership. That should be true even of such an item as inventory transferred in kind. Decisions are not in accord on this interpretation perhaps because it opens up an easy method of transmuting ordinary income into capital gain.

Capital Gain v. Ordinary Income

A capital asset is defined as any property held by a taxpayer, with enumerated exceptions. The principal exception is stock in trade or other property of a kind which would properly be included in the inventory if on hand at the close of the year or property held primarily for sale to customers *in the ordinary course of business.*

If a partnership dissolves and transfers an inventory in kind to the partners who thereafter dispose of it, are the partners holding the inventory primarily for sale in the ordinary course of business? A strong case can be made for the contention that in such a situation the partner has a capital asset and the inventory as to him is not within the exception to the definition of capital asset. This is emphasized by the further fact that the inventory is substituted for his capital interest in the partnership in determining its basis for gain or loss.

In a recent Tax Court case[1] a corporation sold its entire stock of wines to a dealer after its sole stockholder had decided to discontinue the business. The following year the corporation cancelled its lease. The corporation contended that the intent to liquidate the business converted its stock in trade into capital assets, but the Tax Court held that the wine's character as stock in trade was not lost and did not change by virtue of the decision to discontinue the wine business and by the sale of that stock in its entirety. The final word has probably not been written on this issue. The decision would appear to be wrong in that the sale was not made to customers in the ordinary course of business and hence the inventory is within the definition of capital assets.

Income Accrued at Date of Death

Such income is part of the gross estate of a decedent and is of course subject to estate tax. The fact that the income is thus part of the principal or corpus of the estate does not change its character as income for income tax purposes. When collected by the estate, the income is subject to income tax Before the law was changed in 1943, such accrued income was subject to tax in the final return of decedent. It no longer need be taxable to the decedent but may be taxed to the estate or beneficiary who receives it under conditions prescribed in Art. 542 of the regulations.

This question was recently before the Surrogate's Court of Monroe County.[2] The court said that death does not change the character of an asset. If it is an income asset the estate is not relieved of the burden of an income tax when the asset is collected. When received it is taxable as income whether the owner is dead or alive.

The current treatment of income accrued at death is the result of a change in the federal rule in 1942. Congress did not accept the Supreme Court's decision in *Helvering* v. *Enright*[3], which defined accrued income as including a portion of the fee to be earned on matters which the decedent had in his office even though they were not completed (on cases in process). Under the federal rule the income taxed to the estate or beneficiary may be reduced by the portion of the estate tax applicable to

[1] *Grace Bros. Inc.* v. *Commissioner,* 10 TC, No. 21.
[2] *In re Connor's Will,* 75 N.Y.S. (2d) 709, 1/15/48.
[3] 312 U.S. 636, 1941.

the income by reason of its inclusion in the gross estate. The state law does not have a comparable provision covering this deduction.

Social Security Payments

Federal Old Age benefits received under the Social Security Act are deemed to be acquired by gift within the meaning of Sec. 359 (2)(c) of the Tax Law excluding gifts from gross income. The State Tax Commission issued a ruling on January 29, 1948 so holding. Such payments are likewise exempt from federal income tax.

Unemployment insurance payments have also been held not taxable.

Incorporating a Business Conducted by a Single Proprietor

An exchange of property is generally a completed transaction resulting in a realized gain or loss. The law enumerates certain exceptions to the general rule. One such exception is Sec. 354(3), which provides for a non-recognition of a gain or loss if property is transferred to a corporation in exchange for the latter's stock and the transferor is in control of the corporation, control meaning ownership of 80% of the voting stock plus 80% of all other classes of stock. This non-taxable exchange may become a taxable one if the corporation disposes of the property transferred to it within six months of the transfer. Stock in trade is not within this prohibition. The consideration received for the property by the corporation is deemed to be the value of the stock received by the transferor of the property.

Where a taxpayer has transferred his business to a corporation the Tax Commission will seek information from the taxpayer to determine whether the exchange is a non-taxable one, and thereafter it will follow through to see whether the corporation has disposed of any of the property. The procedure is something like this: The taxpayer will receive a letter from the Income Tax Bureau which reads in part as follows: In the audit of your 19— state income tax return, it is noted that you report no business income as sole proprietor. If the business was dissolved and a corporation formed, please submit the following details:

1. A balance sheet of the business of the sole proprietor immediately preceding the transfer of assets to the corporation.
2. A balance sheet of the corporation at its opening, together with all adjusting entries made on the books of account.
3. Indicate the name and address of each stockholder of the corporation, the number of shares of stock held by each, the date of acquisition thereof, how acquired in each case and the basis of computation of the cost price thereof.

New York State Unemployment Insurance Law—Contribution Rate Credits

Under the law an employer is entitled to a credit against unemployment insurance taxes due by him. This is the so called merit rating credit that first appeared in the law in 1945. The credit is based upon three factors: the amount claimed as benefits by former employees, decreases in remuneration paid by employers in successive calendar quarters, and the number of years during which unemployment insurance contributions have been paid. This credit is available to a "qualified employer" and that is defined in the law to mean an employer who in each of the seventeen consecutive completed calendar quarters immediately preceding the computation date was required to file and did file contribution reports which were prescribed by the Commissioner. (Art. 18, sec. 557, Labor Law).

One of our members would like to know what happens to this credit if a business conducted by an individual, partnership, or corporation is disposed of by sale or otherwise and the enterprise is continued by a successor entity. Does the latter acquire any right to this credit? The law has a specific provision on this point. "If an employer has acquired the assets of another em-

ployer who thereafter has discontinued operations, the period of liability of both employers shall be jointly considered in determining the acquiring employer's qualifications for and amount of credits." Also, Sec. 502(3) of the Labor Law includes in the definition of employer a successor of a person, partnership, corporation, etc.

The successor business is required to submit a report (TW-100) to determine liability under the unemployment insurance law. Question 8 reads, "Did you acquire all or substantially all the assets of any previous employer?" If the answer is yes, the employer must state the date of acquisition, the business name of the previous owner, the business address, and the employer registration number of the previous owner. Then follow two other important questions. "Is the previous owner still in business? (8c)" and "Do you assume liability for all unpaid contributions, if any, due from the previous employer (8d)". By answering yes to the last question the successor business may include all wages paid by the previous employer in computing the first $3,000 of remuneration paid to each employee. As a rule the Department of labor will assign the same registration number to the new business that the previous owner had. The report is acknowledged by the Director on Form TW 196.4, and this acknowledgment contains a reference to the predecessor business,. the assumption of predecessor's liability for unpaid contributions, and assigns the registration number of the predecessor to the new owner.

The right to a predecessor's contribution rate credits may be quite valuable and should be taken into account when a business is to be disposed of by sale or otherwise.

The Franchise Tax as a Lien Upon Real and Personal Property

From time to time we hear of cases where a taxpayer has failed to make the second payment due for franchise taxes. Usually such a taxpayer has filed a report and made the first payment at the time of filing but, not receiving a notice of assessment from the Tax Commission, the taxpayer forgets about the balance of franchise taxes that may still be due. What should the taxpayer do when six or seven years later the Tax Commission pounces upon him with a demand for payment not only of taxes but also of penalties and interest? Can the taxpayer set up the Statute of Limitations?

Sec. 213(2) provides that the tax shall be a lien upon real and personal property until the tax is paid in full. This lien may be enforced by the Tax Commission at any time and the usual limitations of time provided in the civil practice act for enforcing a civil remedy do not apply in the case of a tax or penalty under Article 9 or 9A (sec. 219). There are certain exceptions which are not relevant to the issue under consideration. Our taxpayer is on the spot. He cannot escape payment of the tax since there is an existing lien against his real and personal property which the Tax Commission may proceed to perfect and enforce. With respect to penalties and interest the Tax Commission in its discretion has the power to modify these.

The Franchise Tax—Statute of Limitations

Under Section 212 the Tax Commission must audit and state an account within five years after a report is filed. That means that it is required to examine the report, compute the amount of tax payable, and send the taxpayer a notice of his examination. This constitutes the original assessment of the tax. But if for any reason the Tax Commission overlooks the audit and statement of the account, the State is still protected, since the law states that in such a case the Tax Commission is deemed to have assessed a tax in the amount shown on the report. The five year period of limitations will in the latter circumstance protect the taxpayer against any reaudit or restate-

ment of the tax due. But the taxpayer cannot raise this defense against nonpayment of the tax shown on the report within the five year period. The tax due has already become a lien on the date on which the report was required to be filed and the lien is not released because payment of the tax was not made within five years.

New Legislation—Subsidiary Capital, Investment Capital and Business Capital

New Article 9-A developed a more realistic approach to the concept of capital. Under the old law the one mill tax was based upon the value of outstanding capital stock, this presumably representing the capital of the business. New Article 9-A looks upon capital as being represented by assets in a business. If by assets is meant net assets, i.e., total assets less total liabilities, then the one mill tax on net assets would practically be the same as a one mill tax on the value of outstanding capital stock. But new Article 9-A does not base its tax on net assets. It is based upon total assets less liabilities payable by their terms on demand or not more than one year from the date incurred. The effect of this restriction on the liabilities that may be deducted from total assets is to treat long term liabilities as capital and therefore to subject these to the one mill tax.

A bill passed by the legislature would reduce further the liabilities that may be deducted from total assets to arrive at the capital to be subject to the one mill tax. Only those liabilities may be deducted which are *actually demanded and paid within one year from the date incurred.* The changes introduced in this bill modify the definition of subsidiary capital, investment capital and business capital. This change was sponsored by the administration and has been signed by the Governor.

New Legislation—Salary Elimination Basis

Under this basis the franchise tax is computed by taking 30% of the entire net income and adding to this all salaries paid to elected or appointed officers and to every stockholder owning in excess of 5% of the issued capital stock. To this result a deduction may be taken of $15,000. (Until a 1946 change in the law this deduction was only $5,000.) The tax is 4½% of the net result. According to a bill passed by the legislature, it is proposed that this exemption is to be prorated if the period of the return is less than one year. This bill has been signed by the Governor.

New Legislation—Sales Factor

One of the factors in the allocation formula is sales. There is allocated to New York sales of tangible personal property located within the state at the time of the receipt of an order or the appropriation of the property to the order. If the property is not located at any permanent or continuous place of business without the state at the time of the receipt of the order or the appropriation of the property to the order and the orders were received or accepted within the state, the sale is treated as a New York sale. According to a bill passed by the legislature and just signed by the Governor, further content is given to the concept of place of receipt or acceptance of an order. The bill provides that

> "An order shall be deemed received or accepted within the state not only where it has been received or accepted by an employee, agent, or agency chiefly situated at, connected with or sent out from a permanent or continuous place of business of the taxpayer within the state but also in the case of a taxpayer having a permanent or continuous place of business within the state, by an employee, agent, or agency not chiefly situated at, connected with, or sent out from a permanent or continuous place of business without the state."

New Legislation—Election to Apply Business Allocation Percentage to Entire Net Income

Under the present law a corporation may apply its business allocation percentage to entire net income if invest-

ployer who thereafter has discontinued operations, the period of liability of both employers shall be jointly considered in determining the acquiring employer's qualifications for and amount of credits." Also, Sec. 502(3) of the Labor Law includes in the definition of employer a successor of a person, partnership, corporation, etc.

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New Legislation—Election to Apply Business Allocation Percentage to Entire Net Income

Under the present law a corporation may apply its business allocation percentage to entire net income if invest-

ment income is less than 25% of entire net income. According to a bill passed by the legislature this election is available only if in addition to the investment income requirement, investment capital is less than 25% of total business and investment capital.

New Form 3CT(48)— A Correction Noted

In the new Form 3CT (48), Question 3, Schedule J, removes an ambiguity in the phraseology of the corresponding question of last year's 3CT (47). The revised question clearly distinguishes between "a regular place of business" and "a permanent and continuous place of business."

The ambiguity in last year's question was noted by Sidney I. Roberts in the June, 1947, issue of the New York State Tax Clinic (page 400). It is gratifying to call attention to this further instance of cooperation between the State Tax Commission and accountants in facilitating the administration of the tax law. In New York Tax Service Report Bulletin 21, dated March 22, 1948, Prentice-Hall summarizes the differentiation between a regular and a permanent and continuous place of business. A regular place of business need not be occupied by the taxpayer, need not have regular employees regularly in attendance, and can be a public warehouse. A permanent and continuous place of business must be regularly maintained, occupied and used by the taxpayer, must have regular employees regularly in attendance, and may not be a public warehouse.

New Legislation—Change of Classification—Sec. 182

A real estate corporation pays a tax of two per cent on dividends paid during the year. The term dividends includes 90% of interest paid to stockholders or members of their families owning in the aggregate more than five per cent of the issued capital stock of the corporation. The law has also subjected a corporation to a two per cent tax on its earned surplus at the time of dissolution. The 1948 legislature recently amended Section 182 to provide that upon dissolution, merger or consolidation or upon a change of classification from that of a real estate corporation, the additional tax of two per cent shall be paid upon the net worth of the corporation in excess of its actual paid in capital. This law has already been signed by the Governor and is effective as of March 5, 1948. It should be noted that net worth is determined on the basis of the actual or full value of the assets and not the book value.

Exemption for Dependents

The provisions for this credit are different from the present federal rule. A credit of $400 is allowed for a dependent receiving his chief support from the taxpayer, but the dependent must generally be under 18 years of age. If the dependent is mentally or physically defective and therefore incapable of self support he will qualify as a dependent regardless of age and, since 1943, a taxpayer may take a credit for a dependent over 18 years of age if he is in full time attendance at an approved school or college. The dependency credit may be prorated if the dependency status changes during the year. This rule differs from the federal rule under which the status on the last day of the taxable year determines the full credit without proration.

Accounting at the S. E. C.

Conducted by William W. Werntz

More as to Mr. Caffrey's address:

In the February issue we characterized Mr. Caffrey's address of last fall as "indicating an understanding of the accountant's task and problems that will be gratifying to all practicing accountants." This description has evoked some adverse comment by Mr. Charles H. Towns, whose letter of comment appeared in the April issue. Mr. Towns objected primarily, if not solely, it appears, to the following sentence taken from a generalized statement of what Mr. Caffrey stated he, as a non-technician, expected to get from financial statements:

> "I assume that the accountant has told me how much the business made or lost during the year and how much it can pay out without impairing the investment."

This statement is objected to as fallacious because, in Mr. Towns' words, "presumably the word 'investment' is intended to mean the same as is meant by 'capital' or similar wording in state laws against impairment" and because Mr. Towns believes "there are few matters on which accountants would more generally agree than this—that accountants' statements do not show, and do not purport to show, generally, how much a company can pay out without impairment of capital."

William W. Werntz, formerly Chief Accountant of the S.E.C., is now associated with Touche, Niven, Bailey & Smart, C.P.A.'s.

Mr. Werntz is a graduate of Yale University and of Yale Law School, and is a member of the Connecticut Bar. He was formerly an instructor of accounting at Yale University and Yale Law School. He was also an accounting consultant to the O.P.A. and the Treasury Department.

Mr. Werntz is the author of numerous articles which have appeared in technical accounting publications. He is Vice-President of the American Accounting Association.

With the latter reasoning there ought to be pretty general agreement, dividend laws being what they are today—a description of the circumstances under which companies may without statutory penalty distribute their assets pro rata to stockholders, by way of dividends. Few of such statutes limit "dividends" to earnings in either the accounting or the economic sense, but instead permit dividends to be paid out of contributed capital or even perhaps out of unrealized profits. As a result, the accounting distinction between capital and retained earnings seldom, if ever, reflects the exact statutory formula, although under some laws it may approximate it.

With the first point, that Mr. Caffrey "presumably" had in mind dividend laws and availability of surplus for dividends in the legal sense, we have grave doubts, though one cannot say with certainty what may have been in the speaker's mind. In view of the facts that the Public Utility Holding Company Act of 1935 contains specific dividend provisions which have been at issue during Mr. Caffrey's tenure, in numerous utilities cases dividend restrictions have been involved in or resulted from proceedings before S.E.C., and that the cost basis of accounting receives special emphasis in utility accounting, we venture to suggest that Mr. Caffrey, as an attorney and as a commissioner, is quite familiar with the difference between financial or accounting capital and income, on the one hand, and legal capital and surplus available for dividends, on the other. Indeed, it would seem that the quoted language had been rather carefully chosen to refer specifically to the economic and accounting division between capital and income which results in the accounting distinction ordinarily made between capital or capital surplus, on the one hand, and earned surplus, on the other, a distinction made without representation as to whether dividends can or cannot be paid out of capital

surplus, but certainly made with the representation that if there are statutory or contractual restrictions on the availability of *earned* surplus for dividends, they will be appropriately disclosed.

We feel that the "presumably" inference is erroneous for another reason. In most companies dealt with by S.E.C. impairment of legal capital is but rarely the effective criterion as to whether a dividend is or is not to be paid. Cash position, future needs of the business, and similar business circumstances are by far the more usual determinants, and it should be noted that the quotation very clearly did *not* ask the accountant to express any view as to how much, as a matter of sound business judgment, the company could pay.

If we may speculate a bit as to the overtones of what seems to us to be a rather fair statement of the income and investment thought, perhaps the sentence should be read as a real challenge to accounting to seek means of reconciling its principles to those current economic conditions which have led to widespread challenge of cost as the basis for accounts. It would surely not be wholly wrong to characterize some recent proposals for allowing depreciation on the basis of replacement cost or for expanding the application of LIFO as determined efforts to try to get the financial statements of a company to show "how much it can pay without impairing the investment."

Investment company performance charts:

In a statement issued on April 2, 1948, as Release 1160 under the Investment Company Act of 1940, S.E.C. expressed disapproval of certain practices followed by management investment companies in preparing performance charts to be used in their sales literature, the Commission said:

"Recently certain management investment companies, registered with the Commission pursuant to the Investment Company Act of 1940, have filed, pursuant to Section 24 (b) of the Investment Company Act, sales literature containing graphs and charts purporting to indicate to investors the history of an investment in such companies. Such charts depict the increase in the amount of an investment in the company including as part of the investment all dividends distributed by the company during the period adopted. Similar charts and graphs have appeared in reports distributed by such companies to their security holders and filed with this Commission pursuant to Section 30 of the Investment Company Act.

"Examination of these charts and graphs indicates that they are misleading in that the addition of dividends to the investors' cost of investment introduces a misleading, ballooning distortion in the charts or graphs magnifying the performance history to a level far above that which would result if such dividends were excluded. Moreover, such charts and graphs make it impossible or extremely difficult for an investor to determine what his performance experience would have been if he had made his investment at particular stages of the period purported to be portrayed by the chart or graph. In addition, such charts and graphs give inadequate consideration or omit entirely the inclusion in the investor's actual cost of the sales load which he would have to pay to obtain a participation in the enterprise. Finally, in nearly all cases the period covered is one arbitrarily selected to cover favorable stock market levels.

"The objections to the use of these charts and graphs have been conveyed to individual companies from time to time. However, in view of the increasing tendency of investment companies to employ these charts and graphs in their sales programs and in reports to their shareholders, the Commission deems it important to inform all registered companies of its views in regard thereto.

"The Commission does, however, encourage a presentation of management performance depicted by a table of asset values per share at the end of periodic intervals together with an indication in tabular form of dividends paid during such annual periods, provided the sources of such payments and other pertinent facts are also clearly indicated."

Drayer-Hanson, Incorporated:

This report of investigation pursuant to Section 8(e) of the Securities Act of 1933 deals in a rather unusual manner with the registration statement filed by another promotional company. The report, released as Accounting Series Release #64, criticizes both the text of the statement and the financial data included therein and will be discussed next month.

CORRESPONDENCE

To the Editor of *The New York Certified Public Accountant:*

The September issue of "The New York Certified Public Accountant" contains an article by Mr. Lasser beginning on page 579, summarizing briefly the Society's tax meeting held at Elmira in May. On page 582 there appears an example attributed to Mr. Maurice Austin relating to personal holding company tax computations where long-term capital gains are involved. While Mr. Austin's example seems to follow the path indicated by Form 1120H, it does not, I think, carry out the clear instruction contained in Section 117(c) of the Internal Revenue Code.

If I read Section 117(c) correctly, a personal holding company with net long-term capital gains pays an alternative tax in lieu of its aggregate liability under Sections 13, 14, 15, *and 500* if such alternative tax is less than the tax imposed directly by such Sections; this alternative tax is to be computed upon the net income *exclusive* of the long-term capital gain in the ordinary manner as provided in Sections 13, 14, 15, *and 500,* adding to such amount 25% of the long-term capital gain.

Now if one takes the figures assumed in Mr. Austin's example, excluding the capital gain for the moment and dealing merely with the ordinary income as instructed in Section 117(c), it seems to me one would arrive at a tax under Sections 13, 14, 15, *and 500* of $37,500, computed as follows:

Ordinary income	$50,000
Income tax thereon at 38%	19,000
Remainder of income	$31,000
Deduct—Distributions to stockholders	9,000
Undistributed subchapter A net income	$22,000
Subchapter A surtax at 85% minus $200	$18,500
Aggregate taxes on ordinary income	$37,500

Then, adding the 25% tax on the long-term capital gains, one arrives at a total tax liability of $57,500. Mr. Austin makes the total tax bill only $40,500. The difference of $17,000 is of course 85% of the $20,000 capital gains tax which Mr. Austin deducts in computing subchapter A net income.

It seems to me the statutory instruction is clear that the alternative "partial" tax shall be computed under Sections 13, 14, 15, *and 500* without regard to long-term capital gains (or the tax thereon). Let us test this conclusion, however, by the reasonableness of the results of the computations.

It is generally understood that Section 117(c) permits the accumulation by a personal holding company of long-term capital gains with only the usual 25% tax rate thereon. (Mr. Austin agrees—page 581). Ordinary income is, however, understood to be subject to the penalty surtax unless distributed. The portion of ordinary income left after extracting income tax at 38% and subchapter A surtax at 85% is 9.3% of the income (plus a $200 adjustment for the first $2,000 taxed at only 75%). To the extent dividends are paid, the aggregate of retained and distributed earnings increases by 85% of the dividends. Applying these percentages to the figures involved we arrive at the following:

9.3% of $50,000 ordinary income, plus $200 =	$ 4,850
85% of $9000 dividends =	7,650
	$12,500
75% of $80,000 capital gains =	60,000
Net earnings retained or distributed	$72,500

Subtracting a $57,500 tax liability from $130,000 taxable income leaves the same figure of $72,500. However, Mr. Austin arrives at net earnings of $89,500. This difference of course is the previously mentioned 85% of capital gains. Which result is intended by Section 117(c)?

Perhaps the matter can be pointed up by changing the figures very slightly, i.e., by assuming the net long-term gain to be $88,000 instead of $80,000. I show below in parallel columns Mr. Austin's example and the similarly computed result of increasing the long-term gains to $88,000:

	Mr. Austin's Example	*Capital Gains Increased to $88,000*
INCOME TAX		
On ordinary income	$ 19,000	$ 19,000
On long-term gain	20,000	22,000
Total income tax	$ 39,000	$ 41,000
PERSONAL HOLDING COMPANY'S NET INCOME		
Net income	$130,000	$138,000
Less: income tax	39,000	41,000
	$ 91,000	$ 97,000
Less: distributions to stockholders	9,000	9,000
	$ 82,000	$ 88,000
Net long-term gain	80,000	88,000
Balance	$ 2,000	...
TAX		
Personal Holding Company tax on balance at 75%	$ 1,500	$ ...
25% tax on long-term gain	20,000	22,000
	$ 21,500	$ 22,000
25% tax on long-term gain paid on Form 1120	20,000	22,000
Personal Holding Company's tax	$ 1,500	$ ...
TOTAL INCOME AND PERSONAL HOLDING COMPANY TAXES	$ 40,500	$ 41,000

As will be seen, by following this method $8,000 of capital gains increase the tax bill only $500 and the personal holding company surtax is entirely eliminated by the long-term gains although the company has $50,000 of ordinary income and distributes only $9,000 to its stockholders.

Stated simply the question is—can a personal holding company avoid penalty surtax on all its ordinary income by merely realizing capital gains 2½ times as great? Or one can phrase it thus—can a personal holding company use its ordinary income to pay capital gains tax and then accumulate 100% of the capital gains, instead of the 75% one would expect? I doubt that either result was intended.

I am commenting at such length on this point because it seems there has been considerable confusion as to how the alternative tax is to be computed by a personal holding company. Several articles in tax publications in 1945 and 1946 added to, rather than, dispelled this confusion and the Treasury Department was not very helpful when drafting Form 1120H.

The various problems involved can, I

believe, be easily grasped and a reasonable result arrived at only if Section 117(c) is understood to provide for a computation which (1) excludes the net long-term capital gain from income (2) determines both the income tax and personal holding company surtax on the balance and (3) adds to the aggregate of such taxes 25% of the net long-term capital gain. It appears that this is also the view of the Treasury Department since Section 29.117-3 of Regulations 111 provides that

> ". . . this alternative tax is the sum of (1) a partial tax computed at the rates provided by sections 13, 14, 15, . . . and 500 on the net income of the taxpayer, excluding therefrom for this purpose the amount of such excess of the net long-term capital gain over the net short-term capital loss, plus (2) 25 percent of such excess."

Yours very truly,

FRANK C. WOLPERT

New York, N. Y.

To the Editor of *The New York Certified Public Accountant:*

This is in response to a letter addressed to you by Mr. Frank C. Wolpert, regarding the extremely condensed summary of some of my remarks on personal holding companies at the May, 1947, Elmira conference, which appeared in the September, 1947, issue of *The New York Certified Public Accountant.*

Mr. Wolpert points out that, in computing the tax on a personal holding company having a net long-term capital gain (in excess of its net short-term capital loss, if any), Section 117(c) provides that, in lieu of normal tax, surtax, and personal holding company tax, an alternative tax (if less) is to be determined by adding 25% of the net long-term gain to partial taxes computed on the basis of the net income reduced by the net long-term gain. From this he concludes, in effect, that a computation of normal tax, surtax and personal holding company tax is to be made as if the long-term gain did not exist, and to the total of these taxes is to be added 25% of the long-term gain—the aggregate then representing a combined tax, in lieu of the Chapter I and Chapter 2-A taxes. The issue that he takes (supported by cogent reasoning) with the published illustration is that, in such illustration, the tax on the net long-term gain, when computed on Form 1120, is treated as a deduction in arriving at undistributed Subchapter A net income, whereas, under his construction, such tax should be omitted from all calculations until the final addition thereof to the partial taxes at the very end.

It will be helpful, I believe, to point out that the illustration, as published, was only half of the illustration actually included in the outline material distributed to the audience at the Elmira conference and at the earlier lecture on the same subject at the Engineering Auditorium. The full illustration follows:

CASE I.

Net long term gain	$ 80,000
Ordinary income, net	50,000
Total	$130,000
Distributions to shareholders	$ 9,000

TAX UNDER CHAPTER I:	*Bureau interpretation*	*Possible literal interpretation*
On ordinary income	$ 19,000	$ 19,000
On long-term gain	20,000	—
Tax under Chapter I	$ 39,000	$ 19,000

UNDISTRIBUTED SUBCHAPTER A NET INCOME:		
Net income	$130,000	$ 50,000
Less income tax under Chapter I	39,000	19,000
Subchapter A net income	$ 91,000	$ 31,000
Less distributions	9,000	9,000
Undistributed Subchapter A net income	$ 82,000	$ 22,000
Less net long term gain	80,000	—
Balance	$ 2,000	$ 22,000
P. H. Co. tax on balance @ 75%-85%	$ 1,500	$ 18,500
25% tax on long-term gain	20,000	—
	$ 21,500	$ 18,500
Less 25% tax on long-term gain paid on Form 1120	20,000	—
P. H. Co. tax	$ 1,500	$ 18,500
Actual total of income and P. H. Co. taxes		$ 37,500
25% of long-term gain		20,000
Total income and P. H. Co. taxes	$ 40,500	$ 57,500

This, it will be noted, includes as a "possible literal interpretation," the very calculation that Mr. Wolpert has made. At the lecture, the difference between the two calculations was discussed at length, together with the origin and probable reasons for the Bureau interpretation.

I should say, at the outset of the discussion, that Mr. Wolpert's interpretation is the same as that which I originally reached when the provision was enacted in 1942, and which I still regard as a possible view of the statute. This appears from the correspondence hereinafter quoted. The major difficulty with this interpretation is, that by arriving at one combined figure in lieu of Chapter I and Chapter 2-A taxes, it does violence to the basic concept that Chapter I and Chapter 2-A taxes are separate taxes, separately assessable and collectible, and subject to separate statutes of limitations, penalties, etc.

Probably the best way of presenting the several phases of the subject is by summarizing its history.

When Form 1120-H for 1942 released in January, 1943, it appeared, from the way it was constructed, that a corporation with a net long-term capital gain might be subjected to a 25% tax thereon on Form 1120 and to an additional 25% tax on Form 1120-H, a total of 50%. I then undertook, as Chairman of the Society's Committee on Federal Taxation, to address the following communication to the Commissioner under date of February 6, 1943:

> "The form of computation of the alternative tax in case of net long-term capital gains, set forth on the 1943 [1942] personal holding company tax returns (Form 1120-H) raises a question of general interest to which we should appreciate an answer for the benefit of our membership and the public at large.
>
> "Section 117(c) (1) provides for an alternative tax *in lieu of the tax imposed by Sections 13, 14, 15 * * * and 500.* This alternative tax, *in lieu of all the other taxes*

mentioned, is to consist of a partial tax computed on the net income exclusive of the net long-term capital gain (reduced by any net short-term loss that may exist), plus 25% of the net long-term gain thus excluded. In other words, the maximum tax on the net long-term capital gain (as thus reduced) is to be 25%, to cover normal tax, surtax and personal holding company tax thereon. From this it would follow that, once the 25% tax on such net long-term gain item has been paid, there is no further normal tax, surtax or personal holding company tax to be paid even if such gain is *not* distributed to stockholders. This appears to be in line with the idea of placing personal holding companies more or less on a parity with individuals having similar income.

"The way in which the return forms (Form 1120, Schedule C, and Form 1120-H) are drawn, however, lends itself to an interpretation producing an entirely different result. Thus, if, on Schedule C of Form 1120, an alternative tax computation is made, the net long-term capital gain item will have been taxed once at 25%. The computation on lines 22 through 32 of Form 1120-H provides for again taxing the same net long-term capital gain at 25%, if not distributed to stockholders. It would thus appear possible, following the return forms, to have the net long-term capital gain item subjected to a total tax of 50%, which it is believed is contrary to the intent of the statute.

"In this connection it is noted that Section 19.117-3 of Regulations 103, as amended by T. D. 5217, approved January 19, 1943, provides:

> 'For any such taxable year this alternative tax is the sum of (1) a partial tax computed at the rates provided by [Code] section 13, 14, 15 * * * and 500 on the net income of the taxpayer, excluding therefrom for this purpose the amount of such excess of the net long-term capital gain over the net short-term capital loss, plus (2) twenty-five percent of such excess.'

This would appear to require a computation along the following lines:

Partial income tax, per line 29 of Schedule C of Form 1120	xxxxx
Partial personal holding company surtax, per line 29 of Form 1120-H	xxxxx
Total partial tax.........	xxxxx
25% of item 25 of Form 1120-H (net long-term capital gain reduced by net short-term capital loss)	xxxxx
Total alternative tax....	xxxxx
Less:	
Income tax liability, per line 41 of Form 1120	xxxxx
Alternative personal holding company surtax...	xxxxx

This result is the personal holding company tax payable if less than the amount determined without regard to the alternative computation.

"Clarification of this point and indication of which is the correct method of computation in such cases would be greatly appreciated."

Considerable difference of opinion within the Bureau on whether the tax should be 25% or 50% was resolved, under date of December 9, 1943, by the following reply to my request for ruling:

"Reference is made to your letter dated February 6, 1943, requesting clarification of a question raised with respect to the computation of the alternative tax in the case of net long-term capital gains on the 1942 personal holding company return, Form 1120-H.

"You contend that once the 25% alternative tax imposed by Section 117(c)(1) of the Internal Revenue Code on the net long-term capital gain in excess of the net short-term capital loss in lieu of the tax imposed by Section 13, 14, 15, 204, 207(a)(1) or (3) and 500, has been computed as provided in Schedule C, Form 1120, there is no further normal tax, surtax or personal holding company tax to be imposed or paid upon the net long-term capital gain.

"Section 117(c)(1) provides in part that a partial tax shall be computed upon the net income reduced by the amount of excess of the net long-term capital gain over short-term capital loss, and the total tax shall be the 'partial tax' plus '25 per centum of such excess.'

"It is the opinion of this office that the provisions of Section 117(c)(1) should not be interpreted to require in the case of a corporation occupying the status of a personal holding company the addition of '25 per centum of such excess' for the purpose of Chapter I, and then another '25 per centum of such excess' for the purpose of the personal holding company surtax.

"The computation set forth in Item 30 of Form 1120-H is to be made and taken into account in Items 31 and 32 only in those cases in which such a computation was not made and taken into account in computing an alternative tax in Schedule C (Form 1120). For example, even though a net

loss is shown in Item 35 of Form 1120 (in which case there is no occasion for the computation of an alternative tax on that Form), the computation on Form 1120-H may show that the taxpayer has undistributed Subchapter A net income due to adjustments reported in Items 2, 3, 4 and 5 on Form 1120-H. Under such circumstances the computation of an alternative tax as set forth on Form 1120-H is necessary, and in such computation 25 percent of the excess of net long-term capital gains over net short-term capital losses is to be included in computing the tax liability. On the other hand, in any case where 25 percent of the excess of net long-term capital gains over net short-term capital losses has been taken into account in an alternative tax computation on Form 1120, it should not again be taken into account in computing the tax liability on Form 1120-H. In such case Item 29 on Form 1120-H represents the tax liability on that Form and should be entered as Item 32."

The principal point to be observed in this reply is that the Bureau proposed to deal with the Chapter I and Chapter 2-A taxes *as separate computations*, treating the 25% capital gain tax as part of the Chapter I tax if taken into account in an alternative computation on Form 1120, and otherwise as part of the Chapter 2-A tax.

Form 1120-H for 1943 was changed to accord with this ruling by providing in a footnote to the alternative computation, that, if a 25% long-term capital gain tax was included in an alternative computation on Form 1120, it should be omitted from the alternative computation on Form 1120-H. This covered most situations, but failed to deal adequately with cases in which the alternative computation on Form 1120 gave a larger tax than the ordinary computation, *e.g.*, where other deductions and credits made the normal tax net income and surtax net income less than the net long-term gain, or where, in 1946 and later years, the combined normal tax and surtax rates applicable to the corporation's entire income, including capital gains, was 25% or less. (Some practitioners solved this problem by employing the alternative computation on Form 1120 even where it produced a larger tax on that form.)

By reason of this and other difficulties, one of the members of the Society requested a further ruling, to which the Commissioner responded, under date of March 8, 1946, as follows:

"Reference is made to your letter dated September 4, 1945, referring to an article by J. Stanley Halperin, Esq., in the June 1945 issue of Taxes, and requesting advice as to what normal tax, surtax and personal holding company tax would be payable by a personal holding company having a net long-term capital gain of $100,000.00 and no other income.

"It is your contention that the excess of net long-term capital gain over net short-term capital loss should not be taxed in excess of 25 percent and to accomplish this end the normal tax, surtax, and personal holding company tax should be aggregated for the purpose of comparing the total tax liability computed without the benefit of Section 117(c)(1) of the Internal Revenue Code with the total alternative tax provided for in that Section.

"Section 117(c)(1) of the Code provides that the alternative tax shall be in lieu of the tax imposed by Sections 13, 14, 15, 204, 207(a)(1) or (3) and 500, only if such tax is less than the tax imposed by such sections, therefore, the total tax liability of a personal holding company, having no other income than a net long-term capital gain of $100,000.00 would not be in excess of $25,000.00.

"In the situation where a personal holding company is liable, under Chapter I, for a normal tax and surtax on net long-term capital gains at an effective rate of less than the alternative tax rate of 25 percent provided by Section 117(c)(1) of the Code, the terms of the statute in effect permit an allocation of the alternative tax necessary to bring the tax on such income, included in the undistributed Subchapter A net income, up to a maximum of 25 percent. The simplest method of determining the total liability prescribed by the Code would first require a Chapter I computation and determination of the effective rate to which the net long-term capital gain would be subjected. The amount shown to be due would be assessable as the Chapter I tax on Form 1120. However, when the alternative tax computation is being made for the personal holding company return, the amount shown to be due may be reduced by the portion of the Chapter I tax attributable to the net long-term capital gain. The resulting figure should then be entered on line 28 of Form 1120-H for 1945 as the personal holding company surtax with respect to the excess of net long-term capital gain over net short-term capital loss."

Form 1120-H, 1946 and 1947 versions, follow this ruling.

It is to be observed that the Commissioner persisted in treating the Chapter I and Chapter 2-A taxes as separate computations, despite the suggestion that the aggregate method be used. Particularly is to be noted the following language:

> "The simplest method of determining the total liability prescribed by the Code would first require a Chapter I computation***. The amount shown to be due would be assessable as the Chapter I tax on Form 1120."

Although it is possible that the Bureau's present position is the result of having embarked upon a course determined by the form of the 1942 version of 1120-H, it is much more probable that the basic reason is the technical necessity of maintaining separation between the Chapter I and Chapter 2-A tax assessments. (An added reason might be the difficulty envisioned in cash basis cases where the Chapter I tax would be deductible in computing Subchapter A net income in the following year rather than the current one.)

However that may be, if the tax on the long-term gain is, in whole or in part, included in a separately assessable Chapter I tax, it would seem to follow inevitably that such Chapter I tax (inclusive of the capital gain tax) is deductible in computing Subchapter A net income, by virtue of the express provisions of Section 505(a)(1)—this, despite the very cogent reasoning which Mr. Wolpert so ably presents.

The entire question depends on the correctness of the Bureau's position that, even in cases involving alternative computation, completely separate Chapter I and Chapter 2-A tax computations must be made, and not an aggregate computation.

Very truly yours,

MAURICE AUSTIN

New York, N. Y.
March 5, 1948.

BOOK REVIEWS

Montgomery's Federal Taxes—Corporations and Partnerships (1947-48)

By Robert H. Montgomery, Conrad B. Taylor and Mark E. Richardson. THE RONALD PRESS COMPANY, New York, 1948. Two Volumes: Vol. I (Gross Income and Deductions) pp. ix + 1015; Vol. II (Taxes, Returns and Administration) pp. iv + 974. $20 for the 2 volume set.

Amongst technical books, Montgomery's Federal Tax Handbook is a perennial best-seller. First issued in 1917, it has gone through thirty annual revisions and editions. In all these years, it has continued to maintain its high quality of freshness and interset unabated.

What is the secret of the unique success enjoyed by this book? The answer will, of course, vary with the interests and needs of the individual reader. To many—the accountant, the lawyer, the business executive, and others, who desire to keep abreast with current developments in federal income taxation without being engulfed in the avalanche of decisions, rulings and interpretations which the judicial and administrative mills grind out each year as seemingly endless grist—the book will commend itself for its clear and concise exposition of the major facets of the subject. Here one can obtain a broad, over-all view of the forest of federal income taxation without getting lost among the trees and thickets of dense undergrowth.

To the tax specialists—who advise taxpayers as to the tax consequences of their projected business transactions, write briefs, and handle tax litigation—Montgomery's handbook is an important tool of research. Like any instrument, it has its useful qualities and its limitations. Many situations arise where the busy tax practitioner desires, for preliminary conference purposes or as a starting point for more intensive research, a compact summary of the doctrinal developments in a particular area of the tax law. Montgomery's handbook is invaluable in providing a quick orientation on any important phase of the income tax law, an introduction to the leading cases on the subject, and a critical evaluation of ruling precedents. However, it cannot and does not purport to serve as a substitute or short-cut for the detailed research, analysis and final synthesis which the careful research analyst must do by painstaking study of the original decisions, opinions, rulings and other primary source materials that comprise the voluminous body of our tax law.

A treatise like Montgomery's, although it may carry the imprimatur of his distinguished name, is quite obviously not the work of one man. Co-authors with him are Conrad B. Taylor and Mark E. Richardson who, in their own right, have established an outstanding reputation in the field of tax law. The task of producing a work of this character is truly prodigious. Besides the principal authors, 49 partners and associates participated in the basic revision of the text, not to mention the host of research workers and staff assistants whose contributions rest in the shade of anonymity.

One cannot compress into a book-review length summary the contents of this two-volume treatise on Federal Taxes, which covers 1,809 pages of textual material. Those who are familiar with prior editions of this work need no introduction to its scope and content. Those who have not yet discovered this book should not be denied the stimulating experience of exploring

for themselves this vast storehouse of information on the workings of the Federal income tax law.

SAMUEL JOYCE SHERMAN

c/o Eisner & Lubin
New York, N. Y.

Advanced Accounting

By Arnold W. Johnson. RINEHART & COMPANY, INC., New York, 1948. Pages x + 499; $5.00.

In this text, which supplements two others by the same author on Elementary Accounting and Intermediate Accounting, twelve subjects are covered in eighteen chapters. For the most part, problem material is used to illustrate the points under discussion.

The two beginning chapters are on partnership accounting. The first chapter deals with definition of a partnership, why partnerships are formed, and the like. This chapter, except insofar as it serves to provide a background for chapter 2, might well have been omitted. The topics are elementary, rather than advanced, and sketchily treated—recognized by the author through references to more detailed discussion in his text on Elementary Accounting. The second chapter deals with problems of dissolution. This chapter is well written and amply illustrated.

Chapter 3 deals with joint venture accounting. Four distinct methods of accounting for such ventures are discussed and illustrated.

Home office and domestic branch accounting is treated in one chapter. A subsequent chapter deals with the special problem encountered with foreign branches or subsidiaries—the conversion of the profit and loss and balance sheet items of the branch or subsidiary into terms of United States dollars equivalents. The theory of foreign exchange is discussed, and generally accepted rules for conversion are presented.

Consolidated financial statements are given the most complete treatment, their discussion taking almost half the pages in the text. Five chapters deal with consolidated balance sheets, and one with consolidated profit and loss and surplus statements. These chapters are thorough, well written, and include a number of matters that are often ignored or accorded only inadequate textual treatment — matters such as premium and discount on intercompany bonds; purchase of stock of subsidiaries at different dates; partial sales of controlling interests; sales of unissued or treasury stock to minority interests; and mutual stock ownerships. A little additional discussion of the consolidated surplus statement could have been given with advantage, as the preparation of this statement always causes considerable difficulty to the student.

The chapter on consolidations and mergers presents an interesting and helpful discussion of the problems of valuation that arise in connection with such amalgamations, and on methods of allotment of securities to the stockholders of the constituent companies. The accounting procedure in consolidations and mergers is, however, disposed of somewhat too lightly. The chapter on consolidations and mergers is logically complemented by a chapter that deals with the preparation of statements for financing and capital readjustments.

The statement of affairs, receivership accounting, and the statement of realization and liquidation constitute the subject matter of the next three chapters. All three subjects are adequately treated; and in connection with the statement of realization and liquidation, after presenting the statement in usual form, a revised form is suggested that has much merit.

It is to be noted, however, that in his preface the author has stated that the book deals substantially with those specialized problems "likely to be encountered." Yet in connection with

the statement of affairs he points out that it has not yet been accepted by the courts, that creditors are not educated to an understanding of the statement, and that businessmen prefer the ordinary balance sheet with notes as to realizable values, preferences, encumbrances, and so on; and in connection with the statement of realization and liquidation, that it is used more in academic circles than in actual practice. In harmony with the expressed scope of the book, therefore, it would seem that the chapters devoted to these two statements might better have been used for other topics more frequently met with in practice.

The final two chapters deal with accounting for estates and trusts. These chapters include brief explanations of terms peculiar to estates and trusts, and steps in the administration of the estate of a decedent, as well as description and illustration of the accounting phases. A section on distinctions between principal and income in estate and trust accounting is particularly helpful.

The book is well organized from a teaching viewpoint. Ample practice material is made available, the text containing over 200 supplemental problems.

EDWARD J. KOESTLER

Pace Institute
New York, N. Y.

Auditing—An Introduction, and Illustrative Audit

By E. L. Kohler. PRENTICE-HALL, INC., New York, 1947. Pages: iv + 252, and Index; $8.00.

Accountancy educators will undoubtedly agree that the student can obtain a more practical knowledge of auditing from actual work in the field than by means of lectures and text book instruction. In some instances, accounting firms have been requested to permit the presence of students at auditing engagements so that they may observe, and perhaps participate to a limited degree in, the actual day by day procedures in the field.

In the absence of such personal experience, the student must obtain much of his practical auditing knowledge from an adequate text book. Some auditing volumes serve as reference books, which are consulted not only by students, but even by experienced accountants in connection with their daily problems or for the purpose of ascertaining an authority's professional opinion on a controversial topic. Other auditing books deal with the subject primarily from the practical viewpoint, and seek to acquaint the student with practical auditing procedures. Mr. Kohler's work is in the latter category. He approaches the subject as a practical accountant, and takes the reader through the various stages of the audit, from the negotiation with the client to the rendering of the report, and even to the extent of discussing the billing for services rendered, including the average per diem rates charged by auditing firms.

The opening chapters on "Meaning of Auditing," "Mechanics of Auditing" and "Planning the Audit" should be of great assistance to the beginner in understanding how auditors work and what should be the goal of an audit. The remainder of the 221 pages deals with the procedures to be followed in verifying the balance sheet items and the operations of a business. With respect to each asset and liability, the author discusses the nature of the item, a desirable system of internal control thereof, the auditing procedures, and the balance sheet presentation. He also expresses his views on some of the auditing and accounting principles which are the subject of controversy among practicing accountants.

The book contains helpful and practical suggestions as to the writing of reports and the preparation of financial statements. Auditors' comments, including examples of exceptions and qualifications, are also included. The

text concludes with 31 pages of auditing questions, pertaining to the 15 chapters.

The accompanying set of work papers, the Illustrative Audit, consisting of a separate volume in looseleaf form, is introduced by an explanation of the various work sheets and includes a "permanent file," as well as drafts of the auditor's reports to the management and to the stockholders. Although methods of indexing and contents of auditors' work papers are not standard, the reader should obtain a working knowledge of what a set of accountants' audit papers should contain.

DAVID S. SIEGEL

Klein, Hinds & Finke
New York, N. Y.

Proceedings of New York University Sixth Annual Institute on Federal Taxation

MATTHEW BENDER & COMPANY, INCORPORATED, Albany, New York, 1948. Pages xvi + 1260; $20.00.

This latest collection of lectures on current tax problems successfully accomplishes the difficult feat of presenting tax practitioners with an even more valuable aid than the earlier volumes. The emphasis of the Planning Committee upon the practical treatment of every topic is clearly reflected in the seventy-odd papers published in this year's edition. It is literally true that no conscientious tax practitioner can afford to be without this work as a part of his tax reference library.

This year's volume groups the papers under nine headings:

Estate and Gift Tax Problems
Procedure in Handling Tax Matters
Organization and Reorganization Problems
Purchase and Sale Problems
Tax Accounting Matters
Operation of Businesses
Personal Tax Problems
Excess Profits Tax Problems
Proposals for New Legislation

Such organization of the material in this volume is helpful in reviewing the subjects in which the reader is most interested. Complete tables of all statutory and Treasury regulation references in the papers contained therein constitute another feature which adds greatly to the value of the work as an aid in the study of any specific tax problem. The use of these tables leads the user of the book directly to the pages dealing with the problem in which he is interested.

This year's Proceedings include a very complete and carefully prepared Trial Memorandum used in the mock Tax Court Trial, presided over by the Honorable C. Rogers Arundell, Judge of the Tax Court of the United States. This was one of the events during the two-weeks course conducted by New York University which was attended by tax practitioners from 38 states, the District of Columbia and Puerto Rico.

The thoroughness of treatment and practical approach displayed in the papers presented gives evidence of the tremendous amount of time and study that entered into their preparation. They are clearly intended to be of practical use to qualified tax practitioners, written by men with experience and specialized knowledge in their particular fields. They make readily available to the user the results of an immense amount of painstaking, thorough research covering the tax problems which are most frequently encountered today.

PAUL D. SEGHERS

New York, N. Y.

Accounting Survey of 525 Corporate Reports (Fiscal Years Ending July, 1946, to June, 1947).

By the Staff of the Research Department of the Institute, AMERICAN INSTITUTE OF ACCOUNTANTS, New York, 1948. Pages: iv + 97; $10.

The data presented in this survey were collated pursuant to the authorization, in 1946, by the Council of the Institute, of a long-term program for the

analysis of corporate annual reports. Of the 525 reports studied, 440 were for companies which had filed registration statements with the S.E.C. A wide enough selection of groupings was made to achieve a representative cross-section of industrial companies.

The results of the analysis are presented under five headings:

I. General
II. Balance Sheet
III. Income Statement
IV. Surplus Statement
V. Accountant's Report

Interesting or unusual treatments found in the president's letter, the footnotes, or the accountants' reports have been interpolated at appropriate points in the study. This important study should be in every practitioner's library.

Money Market Primer (A study of the Institutions and Operations of the New York Money Market).

By John T. Madden, Marcus Nadler and Sipa Heller. THE RONALD PRESS CO., New York, 1948. Pages iv + 212; $3.00.

The purpose of this study is to examine the powers of the monetary authorities and the mechanism of creating bank reserves and deposits, and to analyze and interpret the statements and statistical data published by the Federal Reserve banks, the Treasury and the commercial banks. The relations between the Treasury and the Federal Reserve System, as well as the policies of the monetary authorities, are discussed critically. The effects of the war on the money market and on the commercial banks are treated in detail.

Bank Credits and Acceptances in International and Domestic Trade (Third Edition).

By Wilbert Ward and Henry Harfield. THE RONALD PRESS CO., New York, 1948. Pages v + 243; $4.50.

The purpose of this book is to contribute to the avoidance of another period of exchange instability and credit uncertainty, similar to that which, following World War I, first tested our bank credit and acceptance business. It is addressed to the same audience as its predecessor volumes—the exporter, the importer, the banker, the lawyer who advises them, the ever-growing circle of students of international trade and its financing. Its object is to restate in current terms and concrete form what has previously been recorded, and to bring the record up to date.

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